Chapter 3

Introduction to Project Finance

A number of financing options are available for infrastructure projects, and for Public-Private Partnerships (PPP) projects in particular. One of the most common, and often most efficient, financing arrangements for PPP projects is 'project financing', also known as 'limited-recourse' or 'non-recourse' financing. Project financing normally takes the form of limited-recourse lending to a specially created project vehicle which has the right to carry out the construction and operation of the project. One of the primary advantages of project financing is that it provides for off-balance sheet financing of the project, which does not affect the credit of the shareholders or the grantor, and shifts some of the project risk to the lenders in exchange for which the lenders obtain a higher margin than for normal corporate lending. This chapter provides an introduction to project financing.[1]

1. OFF-BALANCE SHEET

Project financing may allow the shareholders to keep financing and project liabilities 'off-balance sheet'. Project debt held in a sufficiently minority subsidiary is not consolidated onto the balance sheet of the respective shareholders. This reduces the impact of the project on the cost of the shareholder's existing debt and on the shareholder's debt capacity, releasing such debt capacity for additional investments. Clearly, any project structure seeking off-balance-sheet treatment needs to be considered carefully under applicable law and accountancy rules.

To a certain extent, the grantor can also use project finance to keep project debt and liabilities off-balance sheet, taking up less fiscal space. Fiscal space indicates the debt capacity of a sovereign entity and is a function of requirements placed on the host country by its own laws, or by the rules applied by

1. For further discussion of project finance and PPP projects, see Delmon, *Private Sector Investment in Infrastructure: Project Finance, PPP Projects and Risk*, 2nd edn (2009), this chapter is adapted from it.

supra- or international bodies or market constraints, such as the IMF and the rating agencies. Those requirements will indicate which project lending will be treated as off-balance sheet for the government, for example, the statistical office of the European communities (Eurostat) in decision 18/2004 requires that such transactions must: (i) place instruction risk on the private party (i.e., no completion guarantee from the government); and (ii) the private party must bear either availability or demand risk (i.e., service delivery or market risk).

It should be noted that keeping debt off-balance sheet does not reduce actual liabilities for the government and may merely disguise government liabilities, reducing the effectiveness of government debt-monitoring mechanisms. As a policy issue, the use of off-balance sheet debt should be considered carefully and protective mechanisms should be implemented accordingly.[2]

2. LIMITED RECOURSE AND SPONSOR SUPPORT

Recourse financing provides the lenders with full recourse to the assets or cash flow of the shareholders for repayment of the loan in the case of default by the project company. Where the project otherwise fails to provide the lenders with the repayments required, the lenders will have recourse to the assets and revenue of the shareholders, with no limitation.

One of the advantages to the shareholders of project financing is the absence, or limitation, of recourse by the lenders to the shareholders. The project company is generally a limited-liability, special-purpose project vehicle, therefore the lenders' recourse will be limited primarily or entirely to the project assets (including completion and performance guarantees and bonds).

Non-recourse (sometimes, confusingly, called 'limited recourse') financing limits the lenders' recourse to the assets of the project at hand in case of default by the project company. Limited-recourse financing may be structured in a variety of ways but will usually only provide the lenders with recourse to the assets of the shareholders in certain specified situations, up to a limited maximum amount and over a limited period.

A key question in any non-recourse financing is whether there will be circumstances in which the non-recourse nature of the borrower's liability is to fall away and the lenders are to have recourse to part or all of the shareholders' assets. Generally, the type of breach of covenant or representation which gives rise to this consequence is a deliberate breach on the part of the shareholders, and, in particular, the shareholders not using appropriate efforts to ensure that the project is successful by, for example, committing a breach of

2. See Delmon, *supra* n. 1 ss 1.2.3 and 1.5, for further discussion of off-balance sheet financing.

the operating or joint venture agreement which governs the running of the project. It should also be noted that applicable law will restrict the extent to which liability can be limited, for example, liability for personal injury or death.

Difficult questions arise in relation to the obligations of the shareholders to take up the participation of joint venturers who drop out or default on their obligations, and, in particular, the question of when the shareholders are to be entitled to abandon the project in the event of catastrophe or in the event that the project no longer proves economic. These issues will either be resolved in the drafting of the financing agreement or at law (generally through the law of tort or contract).

Where some portion of the project involves more risk than another, recourse may be provided to the lenders to the extent of that risk or until that high risk period has passed. Alternatively, the amount of recourse allowed to the lenders may be limited in value. The extent to which some recourse is provided is commonly called 'sponsor support'.

Sponsor support may include:

- shortfall guarantees, where the banks, after enforcing all other security rights, experience a shortfall;
- completion guarantees, to ensure the timing and cost of construction (see Box 2.1 below);
- buy-down undertakings, a promise to prepay project debt to ensure specified ratios, in certain circumstances;
- price guarantees, to ensure pricing of off-take;
- market price purchase guarantees, to purchase a minimum quantity of product at market price over a set period;
- tax loss purchases, where a shareholder agrees to purchase certain tax losses from the project company;
- technical support, extended warranties and maintenance arrangements; and
- contingent equity or subordinated debt commitments to cover construction or other price overruns.

Box 2.1 Completion Guarantees

In project financing, the construction phase involves particular risks for the lenders. The value of the project against which the lenders provide financing is usually in the operation and the payment stream supported by the concession agreement and not in the equipment and materials, the physical assets of the project. Since the lenders will bear more risk until construction is complete and asset performance is verified, sponsor support is sometimes provided for the period up to completion of the works and

proven operation, which will generally be defined in the concession agreement and marked by the issue of a certificate or the passing of specified tests. It may also be provided for the period until certain financial ratios are achieved, or until the works have achieved a period of operation at a certain level.

The project company wants to limit the types of breaches resulting in recourse to the shareholders, such as egregious or intentional breaches of essential covenants or representations which may alter the lenders' risk matrix. Sponsor support may involve the establishment of a fund, normally pledged or secured, which can be used, for example, where there is a deficiency of funds or an increase in costs during the period of limited recourse.[3]

Due to the limited-recourse and highly leveraged nature of project financing, the majority of project risks borne by the project company will therefore be borne by the lenders. This makes for extremely risk averse lenders. Therefore, lender due diligence on a project includes a detailed review of whether project risk allocation protects the project company sufficiently. This is known commonly as verifying the project's 'bankability'.[4]

3. TAKING SECURITY

The lenders will want to put in place as much security for the financing as possible. Security is both 'offensive' and 'defensive': offensive to the extent the lenders can enforce the security to dispose of assets and repay debt where the project fails; defensive to the extent that senior security can protect the lenders from actions by unsecured or junior creditors. Complete control requires comprehensive fixed and floating charges (which differ by country) over all project assets, which in common law jurisdictions may allow the lenders to appoint a receiver to manage the business in the event of insolvency. If such comprehensive security rights are not available, the lenders may seek to use ring-fencing covenants in an effort to restrict other liabilities, security over project company shares to allow the lenders to take over control of the company or the creation of a special golden share that provides the lenders with control in the event of default. Security rights may also allow the lenders to take over the project rather than just sell the project assets, since the value of the project lies in its operation and not in completed assets.[5]

3. Tinsley, *Practical Introduction to Project Finance: Structuring and Funding* (1996), 16.
4. For further discussion of bank ability, see Ch. 4 of Delmon, *supra* n. 1.
5. Lender rights to run the project rather than just sell off the assets will require consideration of the applicable legal system and its treatment of security and insolvency. Rights over project company shares may achieve the desired security, but may also involve the lenders taking on project risk.

Lenders want to be protected in the event of insolvency of the project company. The lenders do not want to rely on the generosity of the courts under bankruptcy proceedings, and will therefore want to appoint an administrative receiver to manage the allocation or project company assets to the benefit of its senior creditors. Under certain legal systems, a lender holding security over all project company assets, including receivables and future receivables, can appoint such an administrative receiver. In others, the extent to which lenders can take security over all project assets in the event of insolvency or failure of the project company, may be limited and therefore sophisticated structures must be implemented to achieve the level of security needed by project finance lenders.

A fixed charge attaches to the assets immediately, and such asset can only be disposed of subject to that charge. Under a floating charge, the asset may be managed in the ordinary course of business without reference to the holder of the charge. The charge does not attach to an asset until a specified event occurs, at which point the charge crystallizes and becomes a fixed charge over the relevant assets. Charges may be registerable, which provides the lenders with additional comfort.[6]

The principal lender issues in relation to securing their lending include:

- share pledge or retention (where the lenders can take over ownership of shares);
- security over all (or substantially all) of the project assets and project agreements;
- security over insurance proceeds (as permitted), bonds, guarantees and liquidated damages obligations of the project participants;
- collateral agreements and direct undertakings between the lenders and the parties to the more significant project agreement;
- standby equity or debt;
- legal rights and receivables (in particular the revenue stream) of the project company;
- bank accounts including retention and reserve accounts;
- sponsor support undertakings;
- guarantees from parent companies for their subsidiaries;
- government guarantees;
- default, cross-default and step-in rights so as to give the lenders maximum control over the possible termination, and cure, of any default related to any of the project documents; and
- comprehensive insurances either as co-insureds or assignable to the lenders.

6. See also Delmon, *supra* n. 1 s. 8.14 for further discussion of security rights.

The nature of the security taken over project assets will depend on the provisions of the applicable law and negotiations between the lenders and the project company.

The security rights sought by lenders also include practical control mechanisms, such as reserve discretions (where the project company is limited in the discretion that it can exercise without lender approval). Lenders will also have trigger events, which allow lenders additional rights and powers in the event of their occurrence.

The lenders may want to have rights, through the project company, against persons other than the project company and the project sponsors, such as:

- the off-take purchasers or project users, through for example, 'take-or-pay' arrangements, or 'through-put' agreements in the case of a pipeline or similar project, to guarantee the purchase of a given amount of production or a given amount of use of the project;
- the input suppliers, through for example, 'put or pay' agreements, to supply a given amount of input, such as fuel or raw materials, at a set price;
- the operator, to guarantee proper operation of the project, for example, so as to produce a set output per unit of input;
- the construction contractor, to provide completion guarantees and performance securities ensuring the project meets the performance criteria specified in the construction contract; and
- the insurers, to provide compensation for certain events which might have an impact on the performance and production of the project.

These rights against third parties are set out contractually, including under direct agreements. An immediate issue is whether the type of security provided is recognized or even legal in the site country. Matters of priority of rights and registration of security must be considered, as well as the levels of fees, stamp duty, administrative costs and any subsequent delays which are commonly incurred. For example, in many countries there is no concept of the general floating charge, an instrument used often for United Kingdom-based project financings.[7]

Since the types of security provided will often relate to either real property in the host country or moveable property found within the territory of the host country, the host country's legal system will generally apply to the ownership, seizure and security over such property. Insolvency and bankruptcy laws may also restrict the enforceability of security rights.

The project company may be a wholly owned subsidiary of a shell company which in turn is owned by the shareholders. This can permit shareholder issues to be addressed in a more favourable jurisdiction for providing lender security, voting rights and management arrangements.

7. Rushton & McNair, 'Proceed with Caution', ICL (May 1994): 29 at 34.

Despite the comprehensive security structure to be put in pace by the lenders, it should be noted that the grantor and/or the government will retain reversion rights in those assets needed to provide public services, in order to ensure that no suspension or degradation of public services would result from termination or expiry of the project.

4. FINANCIAL RATIOS

Given the importance of leverage and the sensitivity of lenders to the security of the project revenue stream, a number of financial ratios will be key to the analysis of a project financed transaction. Financial ratios can quantify many aspects of the project company's business and operations and are an integral part of analyzing its financial position. For instance, profitability ratios (e.g., return on equity) measure its rate of return, liquidity ratios (e.g., debt service cover ratio) measure how much cash is available to pay down debt, and debt ratios (e.g., loan life cover ratio (LLCR)) measure the project company's ability to repay long-term debt.

During due diligence, before financial close, lenders run these ratios using various sensitivities, for example, testing the financial ratios in the event construction costs increase by 20%, or revenues fall by 10%. After financial close, the lenders use these ratios as part of the project monitoring and control functions. Where ratios do not achieve the levels required, lenders have a series of possible interventions including blocking distributions, sweeping cash from existing accounts, applying reserve account money to debt service, taking control of additional rights of the borrower or its shareholders[8] and other measures to ensure that the company continues to be managed in a manner focused on successful implementation of the project and earns revenues sufficient to cover debt service. If these breaches persist, eventually, such breaches will amount to events of default permitting the lenders to accelerate, cancel outstanding loan amounts or suspended existing loans. It may also permit them to increase the interest margin, require compensation of the lenders for additional investigation costs and other fees and fines. The following sets out some of the main ratios of interest to lenders.

4.1. Debt-Equity (D:E) Ratio

A company's debt-to-equity ratio is calculated as long-term debt/shareholders' equity. The lenders prefer a lower debt-to-equity ratio in order to obtain a greater investment from the shareholders, ensure shareholder

8. See ss 2.2 and 2.3 on sponsor support and taking security.

commitment to the project, increase the net value of project assets, and provide the lender with greater security arising from the additional equity capital injection into the project, thus increasing the net value of project assets. Shareholders, on the other hand, want an increased debt-to-equity ratio, decreasing the amount of investment they will need to supply and, since the return on debt contributions is fixed, increasing the potential return they can obtain from their equity contributions.

The actual agreed debt-to-equity ratio is the result of a compromise between the project company and the lenders, based on the overall risk to be borne by the lenders, the project risk generally, the nature of the project, the identity of the sponsors, the industrial sector and technology involved, the value of the project and the nature of the financial markets. For example, debt-to-equity ratios for power projects in developing countries tend to be in the order of 80:20 to 70:30, while other projects with higher market risks may not exceed 60%–65% debt.

4.2. Loan Life Cover Ratio

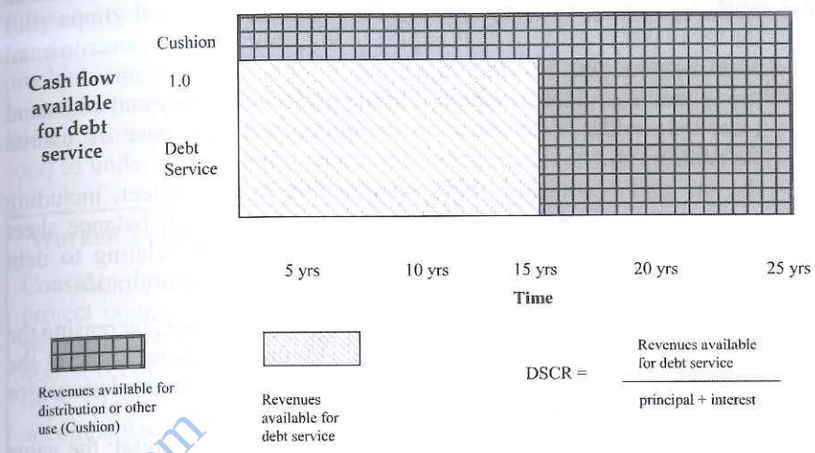
The LLCR is the net present value of available cash for debt service up to the maturity of the credit facilities, divided by the principal outstanding. It is expressed as a ratio representing the number of times the cash flow (over the scheduled life of the loan) can repay the outstanding debt balance.

To verify that the total outstanding debt is not at risk from a shortfall, lenders will apply a minimum LLCR to ensure that the total revenue available to the project company over the life of the loan is adequate to repay and service the total amount of debt outstanding.

4.3. Debt Service Cover Ratio

The amount of payment due to the lenders by the project company at any given time is called debt service, and making those payments is known as servicing debt. The lenders will want to be sure that as and when each payment obligations of the borrower arises, the borrower will have the money available to pay that amount. The lenders will therefore analyse, through the project financial model, the ratio of total amount of revenues available for debt service (e.g., net of operating costs, insurance premia, taxes, etc., but before equity distributions) during a period and compare this to the amount of debt service owed. The debt service cover ratio (DSCR) measures the amount of cash flow available to meet periodic interest and principal payments on debt. Unlike the LLCR, it examines the project company's ability to meet its debt payments with reference to a particular period of time, for example,

Figure 2.1 Debt Service Cover Ratio



annually or semi-annually, rather than over the life of the loan. This assessment can be made forward or backward looking (see Figure 2.1).

4.4. Rate of Return

Rate of return (ROR) or return on investment (ROI), or sometimes just 'return', is the ratio of money gained or lost on an investment relative to the amount of money invested, usually on an annual basis. It includes return earned on both debt and equity. Internal rate of return (IRR) is the discount rate that results in a net present value (NPV) of zero of revenues over the project period, which shows the annualized effective compounded rate of return which can be earned on the invested capital (again, both debt and equity).

Return on equity (ROE), on the other hand, strips out the return committed to debt servicing, providing equity investors with a picture of their return over the period of the project. Private-sector shareholders will expect a high rate of return when they provide equity funding for a project. The actual rate of return achieved by the project company can be influenced by:

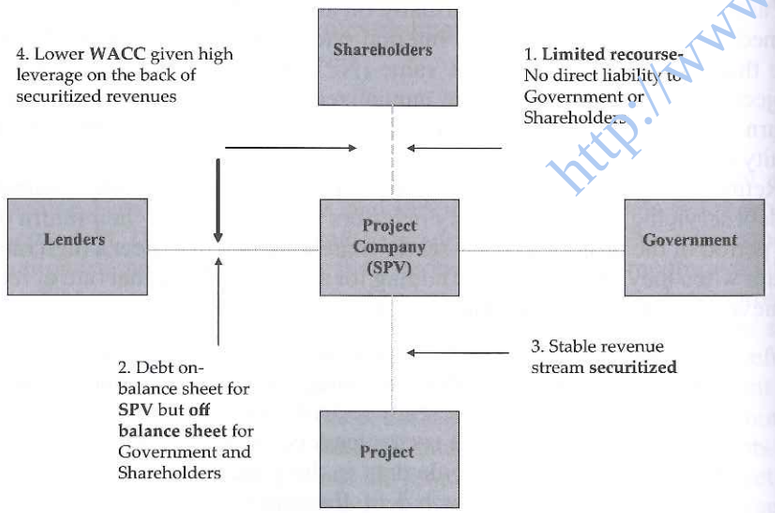
- exchange rates between the local currency and any currency in which debt will be made available, including the cost of exchange and any applicable or potential currency restrictions;
- the willingness of private sector lenders, the capital markets or other interested lenders to provide debt to the project, the interest rates and maturities available for such debt, the debt service cover ratios which

they will require, and other conditions which the private-sector lenders will impose;
- the availability of bilateral, export credit, multilateral, governmental and other funding for the project;
- the leverage of debt-to-equity that the project company can withstand (see below the discussion of weighted average cost of capital (WACC)); and
- the tax and accounting regime applicable to the project, including methods of calculating depreciation, treatment of off-balance sheet financing, and tax treatment of interest payments relating to debt exceeding certain legislatively prescribed debt-to-equity ratios.

Project financing assists investors in maximizing debt leverage, increasing the debt-to-equity ratio and reducing the WACC. Figure 2.2 shows some of the benefits of project finance as they are imbedded in the different relationships amongst project participants.

WACC is used to measure the project company's cost of capital: the value of its equity plus the cost of its debt. WACC is calculated by multiplying the cost of each capital component, such as share capital, bonds and long-term debt, by its proportional weight and then adding these components together. Assuming that interest charged on debt is much lower than the returns sought by equity investors, increasing the amount of debt also increases equity return. This is because the total amount paid by the project company in respect of its

Figure 2.2 Characteristics of Project Finance



debt and equity (measured by its WACC) will be lower compared to a project fully equity financed, thereby leaving the project company with more funds for distribution and an increased ROE. It also allows investors to spread precious equity capital over a greater number of projects (as total equity investment required for each project decreases through better leverage), allowing investors (in particular those with specialist sector expertise – sponsors) to undertake more projects, and thereby deliver more infrastructure.

Worked example of WACC

Consider the following two scenarios where USD 400 is invested in a project company. In scenario 1, the amount is invested fully as equity with a return of 10%. The WACC would be (USD 400×10%)/USD 400 = 0.1. In scenario 2, the project company uses the leverage offered by a 3:1 debt to equity ratio, and so the USD 100 equity investment is accompanied by debt of USD 300 at a cost of say 7%. The WACC in scenario 2 would therefore be [(USD 100×10%) + (USD 300×7%)]/USD 400 = 0.078. The lower WACC in scenario 2 illustrates that the project company will have a lower threshold or cost to overcome before its cash flows create value for shareholders, increasing the return on equity investment.

5. CERTAINTY OF REVENUE STREAM

Future forecasts of demand, cost and regulation of the sector in any relevant site country will be important to private-sector investors considering the revenue prospects of the project. For example, they may wish to:

- review the demand profile for project off-take, in the context of the extent to which the project company will bear project risk and will be able to influence demand;
- examine demand projections and information on the historical willingness of consumers to pay tariffs and to pay such tariffs on time;
- look at prospects for growth, demographic movements, current tariffs and projections of consumer attitudes towards paying increased tariffs;
- where tariffs are based on indices, look at projections of the future movement of such indices and their relation to actual costs, including operating costs, finance costs, capital expenditure requirements and other such costs;
- review public, residential, commercial and industrial consumption and usage, actual and forecast, within the service area; and

Chapter 10
Indonesia

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Chapter 10
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The information and opinions contained in this chapter are the authors' own and are not intended to be a comprehensive study of, or an opinion or advice rendered by the authors regarding, the matters discussed and should not be relied upon or treated as a substitute for specific advice concerning discrete situations. Indonesia's laws (*undang-undang*) generally provide only a framework for further policies, rules and regulations to be implemented pursuant to government regulations, ministerial regulations and regional regulations, among other sources. Any such laws and regulations may be superseded or amended without the text of the superseding or amending law or regulation being immediately made available to the public, and are, in each case, subject to interpretation of and/or implementation by the relevant regulatory bodies, which interpretation and/or implementation may be based on policies not stated in the text of the relevant law or regulation itself. Accordingly, references to particular regulations are generally for illustrative purposes only, unless stated otherwise. Additionally, projects, either noted as past, current or upcoming, are referred to in this chapter from publicly available sources for illustrative purposes only. This chapter has been prepared on the basis of laws, regulations and practice in Indonesia as of May 2012, unless otherwise noted.

On 4 July 2012, the Indonesian government announced the launch of a new book listing Public-Private Partnership Projects and a new standard operating procedure guide for projects, but analysis of these materials has not been included the following chapter.

1. OVERVIEW OF PUBLIC-PRIVATE PARTNERSHIPS IN INDONESIA

1.1. Market Context

The economic fundamentals of Indonesia have remained strong in recent years, despite the global financial crisis and the financial turmoil in the Europe. Fitch Ratings and Moody's Investors Service upgraded Indonesia's sovereign debt rating to investment grade in December 2011 and January 2012, respectively,[1] and market commentators are optimistic that Indonesia's positive economic growth will continue. Nevertheless, the lack of adequate public infrastructure – epitomized to first-time visitors to the nation's capital, Jakarta, by the roadway traffic – has been consistently identified as an impediment to the country's economic growth.[2]

The Government of Indonesia (the central government) has recognized that Indonesia's infrastructure requires private sector involvement and support, through the participation of experienced contractors and operators, as well as equity and debt finance for projects to be implemented privately or under a public-private partnership (PPP) structure (referred to in *Bahasa Indonesia* – the Indonesian language – as *Kerjasama Pemerintah dengan Swasta* or KPS).The central government's development plans have been reported as requiring an estimated total investment of USD 4 trillion[3] and include the construction of the up to USD 15 billion, 31-kilometre Sunda Strait bridge, which would connect Java and Sumatra, the estimated USD 4 billion Central Java independent power plant, with capacity of up to 2000MW (for which a power purchase agreement, and the first guarantee agreement provided by the Indonesia Infrastructure Guarantee Fund, were signed in October 2011),[4] and the estimated USD 1.13 billion railway connecting Manggarai Train Station

1. As of April 2012, Standard and Poor's had deferred increasing its rating of Indonesia to investment grade, due to concerns regarding changes in mining regulations and the government's failure to reform Indonesia's fuel subsidy program. Rieka Rahadiana, 'S&P warns on Indonesia policy moves, forgoes rating upgrade,' *Reuters (U.S. Edition)* (23 April 2012), <http://www.reuters.com/article/2012/04/23/us-indonesia-economy-investment-idUSBRE83M08520120423> (last accessed on 22 May 2012).
2. World Economic Forum, *2010–2011 World Competitivenes Report* (the quality of Indonesia's infrastructure is 'of particular concern'); 'Not Making It Easy: Why business in Indonesia has yet to take off', *The Economist* (10 Sep. 2009); Lynn Lee & Wahyudi Soeriaatmadja, 'Port Pile-Up Highlights Infrastructure Woes; Jams Choke Flow of Goods to Sumatra, Frustrating Drivers and Businesses', *The Straits Times* (2 Mar. 2011).
3. Esther Samboh, '16 PPP Projects to be Auctioned this Year', *The Jakarta Post* (24 Feb. 2011).
4. ITOCHU Corporation, *Execution of Long-Term Power Purchase Agreement for a New 2 GW Coal-Fired IPP Project in Indonesia – Indonesia's First High Efficiency (USC) Coal-Fired IPP Project and Amongst the Largest in Asia* (7 Oct. 2011) <http://www.itochu.co.jp/en/news/2011/111007.html> (last accessed on 22 May 2012).

and Soekarno-Hatta International Airport,[5] together with numerous small and medium-sized projects.

Private infrastructure development is also indirectly encouraged by the demand for Indonesia's natural resources[6] and the resulting need to improve transportation infrastructure to allow for increases in production capacity. For example, in 2010 the Province of Central Kalimantan initiated the tender process for the construction of a 185 km railroad between Puruk Cahu and Bangkuang, which is to be followed by a 175 km railroad connecting Bangkuang and Lupak Dalam seaport.[7] This railway was intended for the transportation of coal and other resources. Billions of dollars in private transportation infrastructure initiatives to enhance coal mining operations in South Sumatra and East Kalimantan have also been announced.[8] Additionally, numerous smelter projects have been announced to facilitate compliance with recent regulatory restrictions on the export of ore and unprocessed minerals.[9]

In short, the potential for project financing in Indonesia is immense. This potential, however, has not yet been fully utilized, due in part to the drastic reduction in infrastructure investment following the Asian financial crisis,[10] perceived legal and political uncertainty following the resignation of President Suharto in 1998 and the *Reformasi* period which followed, and

5. Ministry of National Development and Planning/National Development Planning Agency (*Kementerian Perencanaan Pembangunan Nasional/Badan Perencanaan dan Pembangunan Nasional*), *Public-Private Partnerships-Infrastructure Projects Plan in Indonesia: 2011* (Jakarta 2011) (2011 PPP Book), see also Jakarta Post, 'President Preparing regulation to Speed Up Construction of Sunda Strait Bridge', <www.thejakartapost.com/news/2011/03/24/president-preparing-regulation-speed-construction-sunda-strait-bridge.html> (last accessed 15 Jul. 2011) and Esther Samboh, 'Airport Railway "to Operate in 2014"', *The Jakarta Post* (25 Feb. 2011).
6. PT Bank Danamon Indonesia, Tbk., *Indonesia Economic Outlook 2011: Another Good Year?* (28 Jan. 2011), 15, <www.kadin-indonesia.or.id/enm/images/dokumen/KADIN-168-4895-17022011.pdf> (last accessed 13 May 2011).
7. There are also plans for further development of a railway network linking Kudangan-Kumai (195 km), Puruk Cahu-Kuala Kurun-Kuala Pembuang (466 km), Tumbang Samba-Nanga Bulik (418 km) and Kuala Kurun-Lupak Dalam (390 km). 'C. Kalimantan to build railway network', *The Jakarta Post* (11 Apr. 2010); see also *Public Private Partnership Book of the Ministry of Transportation*, also available at <www.dephub.go.id/files/media/file/transmedia/p3-book-kemenhub.pdf> (last accessed on 4 May 2011) and 2011 PPP Book, *supra* n. 5, v; Capital Investment Coordinating Board (*Badan Koordinasi Penanaman Modal*), dan Koordinasi Penanaman Modal nating Board (/file/transmedia/p3-book-kemenhub.pdf> (last accessed on 4 May 20projects/23> (last accessed on 13 May 2011).
8. See, e.g., sources cited *infra* n. 116. Development in terms of natural resources-based projects may be limited, however, by environmental concerns, including carbon emissions from the use of fossil fuels, land and forest area degradation, and various forms of pollution.
9. 'Raw Commodity Export Ban Sparks Smelter Building Boom in Indonesia,' *The Jakarta Post* (21 February 2012), <http://www.thejakartaglobe.com/economy/raw-commodity-export-ban-sparks-smelter-building-boom-in indonesia/499567> (last accessed on 22 May 2012).
10. 'The Gravy Train Stops', *Far Eastern Economic Review* 161, no. 13 (Hong Kong: 26 Mar. 1998), 49.

the contraction in the global financial markets in 2008 and 2009, and the continuing financial turmoil emanating from Europe thereafter.

1.1.1. History

The Asian financial crisis (1997–1998), the commencement of the *Reformasi* era and resulting efforts to implement political, financial and regulatory reforms in Indonesia contextualize the current state of the market for project financing and PPP in Indonesia. These reforms have included implementation of democratic principles, substantially expanded regional autonomy, ongoing significant regulatory overhaul affecting nearly all major business sectors and areas of the law (with the notable exception that the Indonesian Civil Code and portions of the Indonesian Commercial Code remain essentially unchanged from the Dutch colonial era), and the introduction (or attempted introduction) of market-based mechanisms in sectors previously under total or partial government control.

Private sector investment in Indonesia prior to the Asian financial crisis can be roughly grouped into two major waves. The first wave of investments followed from the major legal reforms implemented by the Suharto administration[11] from 1967 through the 1970s, which investments included the establishment of PT Indosat Tbk. (then known as PT Indonesian Satellite Corp.) by International Telephone and Telegraph Corporation and the first Coal Contract of Work being entered into with a subsidiary of Freeport McMoRan Copper & Gold Inc. The second wave of investments followed the effect of the 'Washington Consensus' on the Suharto administration from the 1980s until 1997, which resulted in build-own-operate (BOO) and build-operate-transfer (BOT) projects and other privatization structures during the 1980s and, to a greater extent, the 1990s, which are generally considered to be the 'first generation' of Indonesian PPPs.[12]

Because the Asian financial crisis resulted in a significant reduction in the value of the Indonesian Rupiah, nearly all internationally financed projects involving entities with Rupiah revenue at the borrower level, or at the offtaker level, and foreign currency debt required some form of restructuring (with some project participants resorting to dispute resolution procedures or litigation). The notable examples of the currency devaluation affecting an

11. These legal reforms include the passage of the Law on Foreign Investment (*Undang-undang Tentang Penanaman Modal Asing*), No. 1 of 1967, the Law on General Mining (*Undang-undang tentang Ketentuan-ketentuan Pokok Pertambangan*), No. 11 of 1967, and numerous others.
12. See generally Gary S. Wigmore & Giles Kennedy, 'Opportunities and Trends in the ASEAN Project Finance Environment', in *Financing Southeast Asia's Economic Development*, ed. Nick J. Freeman (Institute of Southeast Asian Studies, 2003).

offtaker can be found in the independent power producer (IPP) projects of the 1990s.[13] In these projects, PT Perusahaan Listrik Negara (Persero) (PLN), the state-owned electricity company, was required to pay a U.S. dollar-based electricity tariff, under the power purchaser agreement (PPA), to the project company, despite the relative decline in value of the Rupiah, in which tariffs paid by consumers to PLN were denominated. For those projects that had reached financial close, PLN's inability to pay under the PPA ultimately affected each project company's ability to service its debt. As a result, numerous IPPs from that period were restructured or cancelled.[14] Nearly all of the 1990s telecommunications BOT projects were also casualties of the Asian financial crisis,[15] and the privatization of the Jakarta water system was nearly derailed as well.[16]

After the election of President Susilo Bambang Yudhoyono in 2004, the central government made efforts to offer new projects, but investor interest was limited. At the Indonesia Infrastructure Summit in 2005 and 2006, the central government offered more than 100 projects to the private sector,[17] to be carried out pursuant to a PPP programme to be governed, in part, by a specific regulation regarding 'Cooperation between the Government and Business Entities in Infrastructure Procurement', as set forth under Presidential Regulation No. 67 of 2005 (subsequently amended by Presidential Regulation No. 13 of 2010 and No. 56 of 2011), supplemented with a special land acquisition scheme for public infrastructure.[18] However, these efforts – considered to be the 'second generation' of PPP – were generally unsuccessful due to investor dissatisfaction with the application of the land acquisition scheme, the fundamental legal changes still occurring in the country during this period, the uncertainties relating to implementation of

13. See generally Susan E. Turner & Gary S. Wigmore, 'The Disappearing PPA: Moving to Merchant Power in Asia', *Journal of Energy & Natural Resources Law* 19 (2001): 74-75; Louis T. Wells & Rafiq Ahmed, *Making Foreign Investment Safe: Property Rights and National Sovereignty* (New York: Oxford University Press, 2007) (discussing in depth the disputes surrounding Paiton I, and the Karaha Bodas and CalEnergy IPPs, respectively).
14. In 2007, Andrew Kinloch noted in *Project Finance Magazine* that '[o]f the 26 contracts signed with IPPs between 1994 and 1997, 14 were eventually renegotiated; five were acquired by PLN; and seven terminated'. Andrew Kinloch, 'IPPs and buts', *Project Finance Magazine* (December 2006/January 2007).
15. John Ure (ed.), 'Indonesia', *Telecommunications Development in Asia* (Asia: Hong Kong University Press, 2008), 273.
16. Okke Braadbaart, (Privatizing Water: The Jakarta Concession and the Limits of Contract,) *A World of Water: Rain, Rivers and Seas in Southeast Asian Histories*, ed. Peter Boomgaard (Leiden: KITLV Press 2007), 313-314
17. See Shameen, Assif, (SOUNDS OF A BUILDING BOOM; Indonesia, Malaysia, and Thailand are Spending Billions on New Infrastructure', *Business Week* (30 May 2005), 26.
18. This regulatory framework, as amended, is discussed under s. 1.2.1 (*Public-private Partnerships*) and s. 2.6.3.4 (*Acquisition of Land Rights*).

those legal reforms already instituted and the lack of sufficient government financial support for the projects offered.[19]

1.1.2. Today

In recent years, the central government has continued to amend and adjust the legal and institutional background for infrastructure projects, with a view towards implementing the 'third generation' of PPP projects. Initiatives have included significant amendments to the applicable regulations relevant to PPPs, and the establishment of two new state-owned enterprises, the Indonesia Infrastructure Guarantee Fund (IIGF) (formally known as PT Penjaminan Infrastruktur Indonesia (Persero)), and PT Sarana Multi Infrastruktur (Persero) (SMI), to provide credit support and financing, respectively, for projects[20] and various legal reforms. Many of these policy efforts were intended to culminate with the Central Java independent power plant (CJIPP), with capacity of up to 2000MW, tendered by PLN (with the advisory services of the International Finance Company (IFC)), which is the first PPP/IPP project that features credit support from the IIGF. The power purchase agreement and the IIGF guarantee agreement (with a co-guarantee from the Minister of Finance acting on behalf of the central government) for CJIPP were signed in October 2011.[21]

The enhanced institutional framework for PPPs is expressly focused on the process of competitive tender (subject to certain exceptions), as well as the development of government institutions – including the Public-Private Partnership Central Unit (P3CU) of BAPPENAS, the Coordinating Minister of Economic Affair's Policy Committee for Accelerating the Provision of Infrastructure (KKPPI) and the Ministry of Finance's Risk Management Unit (RMU) – to facilitate implementation of PPPs.[22] Additionally, a Project Development Facility (funded by the Asian Development Bank (ADB) and the Government of Netherlands as part of the Infrastructure Reform Sector Development Programme) was established to provide technical advisory services and procurement administrative services to assist BAPPENAS and regional governments in connection with

19. In 2010, coordinating Economic Minister Hatta Rajasa was quoted in *the Jakarta Post* as admitting 'Previously we were not well-prepared in terms of regulations relating to PPP. Some regulations did not allow the participation of private enterprises. Now regulations are more liberal, allowing PPP or even entirely private ventures.' Aditya Suharmoko, 'RI better prepared for public-private partnerships', *The Jakarta Post* (16 Apr. 2010).
20. See s. 2.7.1 (*Indonesia Infrastructure Guarantee Fund*) and s. 2.7.3 (*Indonesia Infrastructure Financing Facility*).
21. See *supra* n. 4.
22. See ss 1.2.3 (*National Government*), 1.2.1 (*Public-private Partnerships*) and 2.7 (*Government Support*) for further discussion on these institutions.

project preparation.[23] In the field of IPPs, March 2010 saw the financial closings of the Paiton III expansion project (an 815 MW supercritical coal-fired plant) and the Cirebon 660 MW coal-fired plant, both of which benefited from the JBIC Umbrella Note of Mutual Understanding.[24] Additionally, in recent years, Indonesian banks signed definitive agreements for the financing of numerous toll roads.[25] The central government and multilaterals like ADB and the World Bank appear intent on extending this positive momentum in IPP and toll road development to other sectors, specifically railway, ports and water projects.

Nevertheless, many of the more ambitious projects have faced delays and uncertainty in the project scope and the tender schedule. For many projects, the government has attempted to address these issues by cancelling or restructuring some proposed projects and increasing the resources provided for the development of others. For example, in 2011 and 2012, the Ministry of Finance, through SMI, has undertaken efforts to revitalize the project development and procurement process for the Soekarno-Hatta Airport – Manggarai Railway PPP project and the Umbulan Water Supply PPP project (both of which have had a relatively long gestation period).[26]

Additionally, in December 2011 the Indonesian legislature approved a new law on land procurement for public use, which provides a basis for compulsory acquisition of land from private parties for purposes of public infrastructure projects.[27]

Undoubtedly, the cross-sectoral PPP framework has been significantly improved in recent years. Concerns remain regarding, among other things, the possibility of delays from land acquisition and permitting procedures, a perceived lack of defined and efficient intergovernmental coordination (i.e., among the central government and its various regulatory agencies, the provinces and the regencies), and the need for capacity-building for regional government personnel assigned to oversee capital intensive and highly regulated projects. However, these concerns may be addressed, in the near term, by the availability of IIGF risk cover and developers and financiers thoroughly assessing project risks (especially in the development and construction stage) thoroughly in the pre-feasibility stage, and, in the long-term, by

23. See Infrastructure Reform Sector Development Program, <http://irsdp.org/?lang=en> (last accessed on 10 Jun. 2011).
24. See s. 2.7.2 (*Other Forms of Government Support*).
25. 'Four Lend into Trans-Java Toll Road', *Project Finance Magazine* (8 Jan. 2010).
26. Minister of Finance Decree on the Appointment of the PT Sarana Multi Infrastruktur (Persero) for Facilitating the Preparation of PPP Projects (*Keputusan Menteri Keuangan tentang Penugasan Kepada Perusahaan Perseroan PT Sarana Multi Infrastruktur (Persero) untuk Fasilitasi Penyiapan Proyek Kerjasama Pemerintah dengan Badan Usaha*), No. 126/KMK.01/2011.
27. Law on Land Procurement for Public Purposes (*Undang-Undang tentang Pengadaan Tanah bagi Pembangunan Untuk Kepetingan Umum*), No. 2 of 2012.

continued efforts by the central government to continue to improve the institutional framework to enable more efficient project implementation.

In addition to the PPP initiatives, in many cases, sector-specific regulations allow the development of private infrastructure (e.g., ports, railways and 'captive' power generation facilities).[28]

Government plans for both public infrastructure and facilitation of private commercial initiatives have been highlighted in the Masterplan for Acceleration and Expansion of Indonesia Economic Development (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia* or MP3EI) for 2011–2025, which was published by the Coordinating Ministry For Economic Affairs in May 2011.[29] In May 2012, however, the Committee on the Acceleration and Expansion of Indonesia Economic Development (*Komite Percepatan dan Perluasan Pembangunan Ekonomi Indonesia* or KP3EI) identified various sources of delay facing numerous projects, including uncertainty relating to the issuance of borrow-use licenses for forest areas,[30] gas supply shortages and uncertainties relating to the regulation of mining and PPPs.[31]

As of writing, President Susilo Bambang Yudhoyono is serving his second and final term. Naturally, the lead up to the next presidential election in 2014 has imposed additional uncertainties in relation to the tone and direction of the government's infrastructure and energy policies. The government's approach towards fuel subsidies has remained an especially divisive issue.

1.1.3. Sectoral Overview

1.1.3.1. Electricity

Electricity in Indonesia is predominately provided by either the state electricity company, PLN, which provides electricity to consumers through the national grid, or through captive (or 'self-use') generation facilities. Electricity sold to consumers by PLN is generally either generated by facilities owned by PLN or purchased from IPPs in Indonesia. Geographic areas without access to the national grid may receive limited electricity through power generation facilities owned by cooperatives or through other means (including, under limited circumstances, importation of electricity). Existing generation capacity is primarily oil- and coal-fired, with the government having initiated the first 'fast track' electrification programme to encourage the construction of coal-fired power plants owned by PLN in 2006 (to reduce

28. See, e.g., ss 1.1.3.1 (*Electricity*), 1.1.3.5 (*Railway Infrastructure*) and 1.1.3.6 (*Ports*).
29. An English version of the MP3EI can be accessed at: <http://www.ekon.go.id/media/filemanager/2011/05/27/p/d/pdf_mp3ei.pdf>
30. See s. 2.6.3.3 (*Title Evaluation, Spatial Planning and Conservation Areas*).
31. Agustiyanti, 'Proyek MP3EI Senilai Rp 477,5 T Terganjal Masalah,' *Investor Daily* (14 May 2012).

dependency on fuel oil imports) and the second 'fast track' electrification programme in 2010 to encourage additional IPP projects and renewable energy projects (particularly geothermal).[32]

The 2009 Electricity Law[33] provides the basic framework for the regulation of electricity in Indonesia, including an enhanced role for regional governments in licensing, regulatory oversight and tariff determination.[34] The first implementing regulations under the 2009 Electricity Law, regarding the business of electricity generation (including details of the licensing scheme)[35] and cross-border sales of electricity were promulgated in January and March 2012, respectively. Implementing regulations promulgated under the previous regulations[36] remain effective, so long as they are not contrary to (or have been superseded by) the provisions of the 2009 Electricity Law and its implementing government regulation.[37]

Under the 2009 Electricity Law, an electricity generation license for public use (*Ijin Usaha Penunjang Tenaga Listrik* or IUPTL) authorizes direct sales to consumers and may be held by a state-owned enterprise, region-owned enterprise or a private enterprise.[38] The eligibility of region-owned enterprises and private enterprises to obtain IUPTL is a fundamental departure from the predecessor regulatory framework, under which PLN had an exclusive right to sell to the public. Currently, however, PLN retains a de facto monopoly on sales to the public from the national grid.

IPP projects have been implemented on both a BOO and BOT basis, with the privately owned project company entering into a longer-term power purchase agreement with PLN as offtaker.[39] Appointments of developers for projects generally require a public tender carried out by PLN, subject to certain exceptions. PLN's direct appointment of an electricity selleris permitted in the following scenarios:

32. See s. 1.1.3.3 (*Geothermal*).
33. Indonesia, Law on Electricity (*Undang-undang tentang Ketenagalistrikan*), No. 30 of 2009.
34. 2009 Electricity Law, *supra* n. 33, Art. 5(2), Art
35. Indonesia, Government Regulation on the Business Activities of Electricity Provision (*Peraturan Pemerintah tentang Kegiatan Usaha Penyediaan Ketenagalistrikan*), No. 14 of 2012.
36. Indonesia, Law on Electricity (*Undang-undang tentang Ketenagalistrikan*), No. 15 of 1985 and its implementation in Government Regulation No. 10 of 1989, as amended.
37. 2009 Electricity Law, *supra* n. 33, Art. 57(2); Indonesia, Government Regulation No. 14 of 2012, *supra* n. 35, Art. 54(1).
38. 2009 Electricity Law, *supra* n. 33, Art. 11(1).
39. See Minister of Finance Regulation regarding Methods for the Grant of a Feasibility Guarantee to PT Perusahaan Listrik Negara (Persero) for the Establishment of Electrical Power Generation Utilizing Renewable Energy, Coal and Gas through Cooperation with Private Power Developer (*Peraturan Menteri Keuangan tentang Tata Cara Pemberian Jaminan Kelayakan Usaha Kepada PT Perusahaan Listrik Negara (Persero) Untuk Pembangunan Pembangkit Tenaga Listrik Dengan Menggunakan Energi Terbarukan, Batubara, Dan Gas Yang Dilakukan Melalui Kerjasama Dengan Pengembang Listrik Swasta*), No. 139/PMK.011/2011 of 2011.

- purchases of electricity from power plants that use renewable energy, marginal gas, and coal mine-mouth or from other local energy sources;
- purchases of excess electricity;
- purchases where a local electric power system in a state of electricity supply crisis; and/or
- purchases of additional electricity generated in an already operating facility within the same location.

PLN's direct selection of an electricity seller through the comparison of at least two offers is permitted in relation to purchases of electricity for the purpose of energy diversification for conversion to non-oil sources.[40] Additionally, PLN has been required to purchase electricity from renewable energy power plants with capacity up to 10MW.[41]

IPP projects may be eligible for government- and IIGF-support offered to PPP projects,[42] as well as government supportin the form of a 'business viability guarantee' letter (*surat jaminan kelayakan usaha* or SJKU) from the Minister of Finance.[43] Privately developed geothermal power plants Muara Laboh, located in South Solok Regency, West Sumatra Province, and Rajabasa, located in South Lampung Regency, Lampung Province have received the benefit of an SJKU.[44]

In cases where an IIGF guarantee or other PPP programme support is contemplated, it should be assumed that public tender in accordance with Presidential Regulation 67 of 2005, as amended, is required,[45] even if PLN would otherwise be entitled to engage in direct appointment or direct selection. IPP projects that have been identified as potential PPP projects include three mine-mouth power plants (totaling 2,600 MW) located in Sumatera (PLTU Jambi, PLTU Sumsel 9, and PLTU Sumsel 10).[46]

40. Government Regulation No. 14 of 2012, *supra* n. 35, Art. 25(4) and (3).
41. Minister of Energy and Mineral Resources, Regulation on Power Purchase Price by PT PLN (Persero) From Small And Medium Scale Power Plants Using Renewable Energy Electricity or having Surplus in Electricity (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Harga Pembelian Tenaga Listrik Oleh PT PLN (Persero) Dari Pembangkit Tenaga Listrik Yang Menggunakan Energi Terbarukan Skala Kecil dan Menengah Atau Kelebihan Tenaga Listrik*), No. 04 of 2012.
42. See s. 2.7 (*Government Support*). In February 2012, IIGF and PLN signed a memorandum of understanding on cooperation regarding the preparation of mine-mouth coal-fired power projects. IIGF, Press Release: Penandatanganan Kerjasama Persiapan Proyek PLTU Mulut Tambang, 28 February 2012 <http://www.iigf.co.id/Website/Event.aspx?id=98> (last accessed on 10 August 2012).
43. Minister of Finance, Regulation No. 139/PMK.011/2011, *supra* n. 39.
44. The power purchase agreements (with PLN as offtaker) and SJKUs for these projects were signed in March 2012. GDF SUEZ and International Power, 'Power Purchase Agreements Signed for Two 220MW Geothermal Projects in Indonesia' (2 March 2012) <http://www.iprplc-gdfsuez.com/news/press-releases/2012/02-03-2012.aspx> (last accessed on 30 June 2012).
45. See s.1.2.1 (*Public-private Partnerships*).
46. Oleh Vega Aulia Pradipta, Hanum KD, '3 Mine-Mouth Power Plants To Be Bid,' *Bisnis Indonesia* (20 March 2012).

Projects without access to the national grid (such as mining operations), or where the reliability of electricity is a concern, may establish facilities for captive electricity generation capacity. Such facilities must be licensed by an electricity business license for captive power generation or an 'operational license' (*Izin Operasi*).[47] Permissible uses for captive power generation facilities are continuous self-use, capacity for reserve electricity, and facilities to be used in emergencies or on a temporary basis only.[48]

1.1.3.2. Mining

Indonesia's rich coal and mineral reserves provide the basis for major existing commercial activities by international and domestic companies, as well as prospects for the development of new projects, based on improvements in excavation technology, changes in commodities markets and anticipated improvements in transportation infrastructure. Promulgation of the 2009 Mining Law[49] initiated a major overhaul of the regulation of hard mining in Indonesia, under which all new commercial mining operations (other than those in state reservation areas) require a mining business license (*Izin Usaha Pertambangan* or IUP).[50] Moreover, in 2012, the Ministry of Energy and Mineral Resources begin implementing domestic processing obligations (a requirement to utilize domestic 'downstream' facilities) known as value-added requirements,[51] requiring that ore and certain other raw materials undergo smeltering or processing in Indonesia prior to export. Regulations have established a timetable for IUP holders to comply with the value-added requirements; prior to January 2014, IUP holders will be permitted to continue to export ore and other raw materials only if certain conditions are fulfilled.[52]

47. 2009 Electricity Law, *supra* n. 33, Art. 1 point 11.
48. Minister of Energy and Mineral Regulation, Decree on Technical Guidelines of Implementation of Governance Duties in the field of Provision of Electricity for Self-use, Provision of Electricity for Public Use and Electricity Support Services (*Keputusan Menteri Energi dan Sumber Daya Mineral tentang Pedoman Teknis Penyelenggaraan Tugas Pemerintahan di Bidang Usaha Penyediaan Tenaga Listrik untuk Kepentingan Sendiri, Usaha Penyediaan Listrik untuk Kepentingan Umum dan Usaha Penunjang Tenaga Listrik*), No. 1455K/40/MEM/2000 of 2000, Attachment I, IV – *Perizinan* (1) (e).
49. Indonesia, Law on Mineral and Coal Mining (*Undang-undang tentang Pertambangan Mineral dan Batubara*), No. 4 of 2009.
50. 2009 Mining Law, *supra* n. 49, Art. 1(7), Arts 35 and 36.
51. See, e.g., 2009 Mining Law, *supra* n. 49, Arts 102 and 103.
52. Minister of Energy and Mineral Resources, Regulation on Increasing the Value of Minerals through Processing and Refining (*Peraturan Menteri Energi Dan Sumber Daya Mineral tentang Peningkatan Nilai Tambah Mineral Melalui Kegiatan Pengolahan dan Pemurnian*), No. 7 of 2012, as amended by Minister of Energy and Mineral Resources, Regulation on Amending Minister of Energy and Mineral Resources Regulation No. 7 of 2012 on Increasing the Value of Minerals through Processing and Refining (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Perubahan Atas Peraturan Menteri Energi dan Sumber Daya Mineral Nomor 07 Tahun 2012 tentang Peningkatan Nilai Tambah Mineral Melalui Kegiatan Pengolahan dan Pemurnian Mineral*), No. 11 of 2012.

An IUP is issued for a particular mineral to authorize either exploration activities or production activities.[53] Every holder of an exploration license fulfilling the relevant legal requirements is guaranteed a production operation license, in connection with the 'upgrading' of activities in an area from exploration to exploitation.[54] IUPs with respect to non-metal minerals or rock are obtained by means of an application,[55] and IUPs with respect to metal minerals or coal are obtained by means of an auction.[56] The maximum duration of, and geographic area covered by, an IUP is based on phase of activity (exploration or production) and the applicable mineral.[57] Mining areas in state reservation areas, mining licenses issued to companies with foreign capital investment and existing 'Contracts of Work' with the central government are regulated primarily by the Ministry of Energy and Mineral Resources. Intra-regency and intra-provincial/inter-regency mining operations with only domestic capital investment are primarily supervised by the regents and governors, respectively.[58] Regents and governors also had primarily regulatory authority of intra-regency and intra-provincial/inter-regency mining operations authorized by a Mining Authorization (*Kuasa Pertambangan* or KP), available exclusively for domestic investors prior to the implementation of the 2009 Mining Law and, until the promulgation of

Mining operations must also fulfil numerous regulatory requirements, including to provide a plan for reclamation, a plan for post-mining activities, and a mine closure guarantee (in accordance with the operational age of the mine); to pay annual dead rent and royalties;[59] to prioritize the use of local manpower, goods and services; and to comply with numerous restrictions on the retention of mining service companies.[60] The 2009 Mining Law also imposes value-added requirements, domestic market obligations (DMOs) (a requirement to sell a certain percentage of reserves of specified minerals to domestic purchasers),[61] and a

53. 2009 Mining Law, *supra* n.49, Art. 36.
54. 2009 Mining Law, *supra* n. 49, Art. 46(1).
55. 2009 Mining Law, *supra* n. 49, Art. 54.
56. 2009 Mining Law, *supra* n. 49, Art. 51 (regarding metal minerals) and Art. 60 (regarding coal).
57. 2009 Mining Law, *supra* n. 49. See, e.g., Art. 42(4) (IUP in respect of coal) and Art. 83(g) (Production Operation IUPK in respect of metal mineral and coal).
58. 2009 Mining Law, *supra* n. 49, Art. 48(a) and (b) (in respect of Production Operation IUP).
59. 2009 Mining Law, *supra* n. 49, Arts 99(1), 100(1), 128(4) and 129(1).
60. 2009 Mining Law, *supra* n. 49, Art. 106; Minister of Energy and Mineral Resources Regulation on Mining Service Business (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Penyelenggaraan Usaha Jasa Pertambangan Mineral dan Batubara*), No. 28 of 2009.
61. See Minister of Energy and Mineral Resources, Regulation on Priority for Supply of Minerals and Coal for Domestic Interest (*Peraturan tentang Pengutamaan Pemasokan Kebutuhan Mineral dan Batubara Untuk Kepentingan Dalam Negeri*), No. 34 of 2009. Domestic needs are to be determined by the Minister of Energy and Mineral Resources annually. See, e.g., Minister of Energy and Mineral Resources Decree on Determination of Priority for Supply of Minerals and Coal for Domestic Interest for 2011 (*Keputusan tentang Penetapan Kebutuhan dan Persentase Minimal Penjualan Batubara Untuk Kepentingan Dalam Negeri Tahun 2011*), No. 2360 K/30/MEM/2010 of 2010.

benchmark pricing scheme (which provides the basis for royalty calculations).[62] The extent to which these requirements have been implemented varies depending on the mineral, however: for example, the DMO for coal has been specified by ministerial decree for the years 2010 and 2011 to provide a fuel source for domestic electricity generation.[63]

Additionally (like licenses under the predecessor law), IUPs do not provide surface rights to land.[64] Consequently, a mining license holder is generally obligated to settle the use of land surface rights with any local residents and, as applicable, to obtain the required forest area permits.[65]

The vast majority of existing large commercial mining operations, however, are operated under what is known as the 'Contract of Work' system, established under the 1967 Mining Law.[66] Under the 'Contract of Work' system, the central government would appoint a contractor (which could be a foreign-owned Indonesian entity) to operate mining activities in accordance with an agreement entered into between the central government and such contractor, referred to as a 'Contract of Work' (*Kontrak Karya* or KK), for general mining, or 'Coal Contract of Work' (*Perjanjian Karya Pengusahaan Pertambangan Batubara* or PKP2B)for coal mining, which provided regulation of the contractor's mining activities.[67] Under the 2009 Mining Law, KK and PKP2Bwill remain effective (subject to certain required adjustments) until expiry of their original terms.[68] The President formally established an intra-governmental team for evaluating and establishing the process for re-negotiating the terms of KK and PKP2B in January 2012.[69]

62. Minister of Energy and Mineral Resources Regulation on Methods to Determine the Reference Price of Mineral and Coal Sales (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Tata Cara Penetapan Harga Patokan Penjualan Mineral dan Batubara*), No. 17 of 2010.
63. Minister of Energy and Mineral Resources, Decree on Determination of Priority for Supply of Minerals and Coal for Domestic Interest for 2010 (*Keputusan tentang Penetapan Kebutuhan dan Persentase Minimal Penjualan Batubara Untuk Kepentingan Dalam Negeri Tahun 2010*), No. 1604K/30/MEM/2010 of 2010; Minister of Energy and Mineral Resources Decree No. 2360 K/30/MEM/2010 of 2010, *supra* n. 61.
64. 2009 Mining Law, *supra* n. 49, Arts 134(1), 135, 136(1), 138.
65. See s. 2.6.3.3 (*Title Evaluation, Spatial Planning and Conservation Areas*).
66. 1967 General Mining Law, *supra* n. 11.
67. See generally Jennifer McKay & Balbir Bhasin, tion Areas and Policy in Indonesia: Issues in Current Practice That Need Reform, *Journal Energy & Natural Resources Law* 19 (2001): 329, at 330. Prof. Dr Mochtar Kusumaatmadja's *Rights over Natural Resources: The Indonesian Experience* (Centre for Archipelago, Law and Development Studies, 2002), contains an English language overview of the general issues surrounding the 'Contract of Work' system, as well as other matters relating to natural resources (particularly oil and gas and management of coastal areas) in Indonesia prior to the most recent wave of new laws and regulations.
68. 2009 Mining Law, *supra* n. 49, Art. 169.
69. Presidential Decree on an Evaluation Team for the Adjustment of Contracts of Work and Coal Contracts of Work (*Keputusan Presiden tentang Tim Evaluasi Untuk Penyesuaian Kontrak Karya dan Perjanjian Karya Pengusahaan Pertambangan Batubara*), No. 3 of 2012.

Licenses granted in the form of a Mining Authorization (*Kuasa Pertambangan* or KP) in accordance with the 1967 Mining Law – previously exclusive to domestic investors – were to be converted to IUPs no later than May 2010;[70] a KP that has been converted to an IUP becomes eligible for indirect foreign ownership through a PMA (foreign capital investment company). Due to concerns relating to overlapping mining areas, auction irregularities and potential non-compliance with various requirements initially overseen at the regional government level, the Ministry of Energy and Mineral Resources commenced an evaluation programme of IUPs, with those having demonstrated compliance with various requirement being declared 'Clear and Clean (CNC)'. CNC status is now a pre-requisite for an IUP holder to be eligible to export ore and other unprocessed minerals prior to the full implementation of the value-added requirements (expected in January 2014).

Foreign ownership of mining operations is currently unrestricted under the 2010 Negative List of Investment (*Daftar Negatif Investasi* or DNI).[71] However, under the prevailing regulations all mining companies controlled by foreign investors are subject to partial divestment. Based on regulations promulgated in 2010, at least 20% of the shares in the company must be owned by an Indonesian party after five years of commercial production.[72] Controversially, the divestment requirements were increased in 2012 to require gradual divestment after the fifth year of production so that at least 51% of the shares in the company are owned by an Indonesian party after ten years of commercial production.[73]

1.1.3.3. Geothermal

Indonesia has the largest geothermal energy potential in the world. 40% of the world's geothermal resources are spread out over 265 locations within Indonesia, and the country's geothermal-based power generation capacity remains underdeveloped.[74] Accordingly, the government's second 'fast track' electrification programme of 2010 included numerous geothermal projects (many of which are to be undertaken through cooperation with private

70. Government Regulation on the Implementation of Mineral and Coal Mining Business Activity (*Peraturan Pemerintah tentang Pelaksanaan Kegiatan Usaha Pertambangan Mineral dan Batubara*), No. 23 of 2010, Art. 112(4).
71. See text accompanying n. 282 under s. 2.4.4 (*Regulation of Foreign Direct Investment*).
72. Government Regulation No. 23 of 2010, *supra* n. 70, Art. 97.
73. Government Regulation No. 23 of 2010, *supra* n. 70, as amended by Government Regulation on the Amendment to Government Regulation No. 23 of 2010 on the Implementation of Mineral and Coal Mining Business Activities (*Peraturan Pemerintah tentang Perubahan Atas Peraturan Pemerintah Nomor 23 Tahun 2010 tentang Pelaksanaan Kegiatan Usaha Pertambangan Mineral dan Batubara*), No. 24 of 2012, Art 97(1a);
74. Oxford Business Group, *The Report: Indonesia 2010*, 92.

sector participants in the form of IPPs).[75] Geothermal resource development is separately regulated under the 2003 Geothermal Law and its implementing regulations;[76] geothermal power generation, however, remains subject to general electricity regulations (although some regulations are specific to geothermal power). The 2003 Geothermal Law includes a grandfather provision that applies to any existing geothermal joint operation contract entered into with the state-owned oil and gas company, PT Pertamina (Persero), signed prior to 2003 Geothermal Law, under which such contracts will remain valid until their respective expiry.[77] Currently, Pertamina's subsidiary, Pertamina Geothermal Energy, still holds management rights to fifteen geothermal 'working areas', five of which are being developed under joint operation contracts (and one pursuant to a joint venture).[78]

Other geothermal working areas are to be tendered by the applicable regional government with jurisdiction over the applicable working area.[79] (Representatives from the Ministry of Energy and Mineral Resources are to participate as members of the tender committee for each working area, however.)[80] Prior to the tender of the working area, private entities may undertake a preliminary survey in respect of a working area, with the approval of the Ministry of Energy and Mineral Resources.[81] The surveying party must

75. Minister of Energy and Mineral Resources, Regulation on the Amendment to Minister of Energy and Mineral Resources Regulation No. 15 of 2010 on List of Projects for the Acceleration of Development of Electricity Generation Using Renewable Energy, Coal and Gas and related Transmission (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Perubahan Atas Peraturan Menteri Energi dan Sumber Daya Mineral Nomor 15 Tahun 2010 tentang Daftar Proyek-Proyek Percepatan Pembangunan Pembangkit Tenaga Listrik yang Menggunakan Energi Terbarukan, Batubara dan Gas serta Transmisi Terkait*), No. 1 of 2012.
76. Indonesia, Law on Geothermal Energy (*Undang-undang tentang Panas Bumi*), No. 27 of 2003.
77. 2003 Geothermal Law, *supra* n. 76, Arts 41 and 42.
78. Pertamina Geothermal Energy, *Company Profile, Working Areas*, <www.pgeindonesia.com/index.php?option=com_content&view=article&id=70&Itemid=47> (last accessed on 1 July 2012).
79. 2003 Geothermal Law, *supra* n. 62, Art. 9(1); e.g., Minister of Energy and Mineral Resources, Decree on Stipulation of Geothermal Mining Working Areas in Guci and Baturaden, Province of Central Java (*Keputusan Menteri Energi dan Sumber Daya Mineral tentang Penetapan Wilayah Kerja Pertambangan Panas Bumi di Daerah Guci dan Baturaden, Provinsi Jawa Tengah*), No. 1566 K/30/MEM/2010 of 2010.
80. Minister of Energy and Mineral Resources, Regulation on Guidelines for the Implementation of Geothermal Business Activities (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Pedoman Penyelenggaraan Kegiatan Usaha Panas Bumi*), No. 11 of 2009, as amended by Minister of Energy and Mineral Resources, Regulation on Amendment to Minister of Energy and Mineral Resources Regulation No. 11 of 2009 on Guidelines for the Implementation of Geothermal Business Activities *Peraturan Menteri Energi dan Sumber Daya Mineral tentang Perubahan Atas Peraturan Menteri Energi dan Sumber Daya Mineral Nomor 11 Tahun 2009 tentang Pedoman Penyelenggaraan Kegiatan Usaha Panas Bumi*), No. 18 of 2012, Art. 3.
81. Minister of Energy and Mineral Resources, Regulation on Guidelines for the Assignment of Preliminary Geothermal Survey (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Pedoman Penugasan Survei Pendahuluan Panas Bumi*), No. 2 of 2009, Art. 10.

provide all resulting data to the Ministry of Energy and Mineral Resources and otherwise must keep such data confidential.[82] If a party has conducted a preliminary survey in respect of a working area and does not win the tender of such area, the party is entitled be compensated by the winning bidder for the data produced.[83]

The government has also announced the establishment of a geothermal funding facility, to be administered by the State Investment Agency (*Pusat Investasi Pemerintah* or PIP).[84] The geothermal funding facility is intended to provide a source for regional governments to obtain data regarding geothermal resources prepared by a consultant of international reputation (the data is to be provided is phases, with a total value up to USD 30 million), and for licensed private companies with a potential source of loans to finance exploration.[85] For data provided to regional governments, the cost of such data is to be reimbursed by the winning bidder for the working area.[86]

At the electricity generation stage of the project, the project company would sell electricity generated from the geothermal seal to PLN under a long-term power purchase agreement for geothermal projects (referred to as an energy sales contract). In connection with new working areas, regulations have required that PLN purchase electricity from geothermal IPPs at a price to be determined in connection with the auction of geothermal working area, without further negotiation, so long as the price does not exceed a benchmark price (9.70 U.S. cents/kWh).[87] (The electricity price for working areas held before the issuance of such regulations are to be determined by negotiation with reference to the benchmark price and must be approved by the Minister of Energy and Mineral Resources.)[88] PLN has been required by regulation to prepare a

82. Minister of Energy and Mineral Resources Regulation No. 2 of 2009, *supra* n. 83, Art. 14(1).
83. Minister of Energy and Mineral Resources Regulation No. 11 of 2003, *supra* n. 80, Art. 8(1).
84. Rangga D. Fadillah, 'Govt provides funding facility to encourage,' *Jakarta Post* (9 April 2012) <http://www.thejakartapost.com/news/2012/04/09/govt-provides-funding-facility-encourage.html> (last accessed on 30 June 2012).
85. Minister of Finance, Regulation on the Method of Managing and Accounting for Geothermal Funding Facility (*Peraturan Menteri Keuangan tentang Tata Cara Pengelolaan dan Pertanggungjawaban Fasilitas Dana Geothermal*), No. 03/PMK.011/2012 of 2012.
86. Minister of Finance Regulation No. 03/PMK.011/2012 of 2012, *supra* n. 85, Article 9(4)(b).
87. Minister of Energy and Mineral Resources, Regulation on Designation to PT Perusahaan Listrik Negara (Persero) to Carry Out Purchasing of Electricity from Geothermal Power Plant and Reference Price for Purchase of Electricity by PT Perusahaan Listrik Negara (Persero) from Geothermal Power Plant (*Peraturan Menteri Energi dan Sumber Daya Mineral tentang Penugasan Kepada PT Perusahaan Listrik Negara (Persero) Untuk Melakukan Pembelian Tenaga Listrik Dari Pembangkit Listrik Tenaga Panas Bumi dan Harga Patokan Pembelian Tenaga Listrik Oleh PT Perusahaan Listrik Negara (Persero) dari Pembangkit Listrik Tenaga Panas Bumi*), No. 2 of 2011, Art. 2.
88. Minister of Energy and Mineral Resources Regulation No. 2 of 2011, *supra* n. 87, Art. 5.

standard form of energy sales contract,[89] which can be accessed on PLN's website as a draft contract (*Bahasa Indonesia* version only).[90]

1.1.3.4. *Oil and Gas*

Although Indonesia ceased being a net exporter of oil and a member of OPEC in 2008, oil and gas continues to comprise a major (albeit, in the case of oil, declining) component of business activities in Indonesia.[91] By law, oil and gas activities are categorized as upstream activities (exploration and exploitation) or downstream activities (processing, transporting, storage and trade).[92] (There are no 'midstream' activities recognized by law, and refining is classified as a downstream industry.) The Minister of Energy and Mineral Resources holds general regulatory and policy-making authority in respect of upstream and downstream activities (primarily exercised through the Directorate General of Oil and Gas, known as Migas), while two special administrative agencies – BPMigas (*Badan Pelaksana Kegiatan Usaha Hulu Minyak dan Gas Bumi*) and BPHMigas (*Badan Pengatur Hilir Minyak dan Gas Bumi*) – have specific authority over upstream and downstream activities, respectively.[93] The state-owned oil and gas company, PT Pertamina (Persero) (Pertamina), converted to a *Persero*[94] in 2003 (having lost its legal monopoly and its quasi-regulatory role pursuant to the 2001 Oil and Gas Law[95]), continues to conduct

89. Minister of Energy and Mineral Resources Regulation No. 2 of 2011, *supra* n. 87, Art. 2(5).
90. PLN, *Draft Energy Sales Contract*, <www.pln.co.id/dataweb/ESC/draft_esc_pln.pdf> (last accessed on 4 May 2011).
91. See generally Oxford Business Group, *The Report: Indonesia 2010*, 83; Heather Lehr Wagner, *The Organization of the Petroleum Exporting Countries* (Infobase Publishing 2009), 67. As is the case for oil and gas projects globally, financings of oil and gas projects in Indonesia may possess characteristics not found in financings in other sectors. Financings have been collateralized by long-term y, financings of oil and gas projects in Indonesia may poss (which need not be connected to the project being financed), with no security interest in the project assets or contracts. Additionally, these financings may utilize a trustee borrowing scheme, under which an offshore trustee acts as borrower under the financing and is paid directly by the offtakers. George K. Crozer, 'Pertamina's Blue Sky Project Heralds Return of Innovative Project Financing in Indonesia', Journal of Structured and Project Finance, Spring 2004 (v. 10, issue 1), also available at <www.whitecase.com/files/Publication/ce3ac3c4-f731-46ca-9a0e-af851e2f58d3/Presentation/PublicationAttachment/3e88c5c8-4b38-4ad8-a81b-b49574dd86f5/article_blue_sky.pdf> (last accessed 30 April 2011); Clarinda Tjia-Dharmadi, 'Gas Landmark: Indonesia's First Project under the New Oil and Gas Regime', International Financial Law Review (October 2006).
92. Indonesia, Law on Oil and Gas (*Undang-Undang tentang Minyak dan Gas Bumi*), No. 22 of 2001, Art. 5.
93. 2001 Oil and Gas Law, *supra* n. 92, Ch. IX (Operating Board and Regulating Board) (unofficial English translation of heading).
94. See s. 1.2.5 (*State-owned and Region-owned Enterprises*).
95. See, e.g., 2001 Oil and Gas Law, *supra* n. 92, Arts 61 and 63 (providing for the transfer of responsibilities to BPMigas).

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Chapter 15
Tanzania

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1. OVERVIEW OF PUBLIC-PRIVATE PARTNERSHIPS IN TANZANIA

International Monetary Fund (IMF) figures indicate that from the 1960s to the 1980s the public expenditure of most countries worldwide rose by 2% to 3% a year, and in the early 1970s, thirteen countries were spending close to 30% of their Gross National Product (GNP) in the public sector. By the end of the 1970s, close to ninety countries were spending more than a third of their GNP in the public sector.[1] In the less-developed countries, increased public expenditure was characterized by the growth of the parastatal sector, mainly the state-owned enterprises (SOEs).

In the United Republic of Tanzania (Tanzania),[2] there were fifty SOEs in the mid-1960s. In the late 1960s, the Government of Tanzania (Government) embarked on the creation of SOEs, as Government control was perceived to be vital for the development of the economy of the country and important to maintain strategic control over crucial resources such as petroleum, water, mining, power and energy. SOEs in all sectors of the economy were created, and in some instances, this was achieved through the nationalization of private

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1. Hanke. S.H, 'Privatisation and Development', International Center for Economic Growth, ICC Press 1987.
2. For the purposes of this article 'Tanzania' means mainland Tanzania and does not include Zanzibar.

sector businesses such as insurance, banks and financial institutions. By the late 1970s, there were approximately 400 SOEs in Tanzania.

However, the increase in control by the Government failed to promote the growth of the economy. Many SOEs incurred fiscal losses and were seen as budget drains as increasingly large subsidies were required to maintain these money-losing enterprises. SOEs were poorly run and failed to generate new resources.

Failing SOEs damaged the economy, especially in the banking sector, where loan portfolios were weakened as a result of issuing loans to the ailing SOEs. The Government embarked on finding new ways to mobilize and efficiently make use of its resources. Trade was liberalized, and vast economic and policy reforms were implemented, including a parastatal sector reform policy in early 1992. The main objectives of these measures were to ensure that SOEs were operating efficiently, to reduce the burden the SOEs had placed on the Government budget, to expand the role of the private sector in the economy and to encourage wide participation of Tanzanians in the economy.

Interest in reducing the role of the public sector in national economies gained momentum over the years, as there was a growing conviction that private entrepreneurs can manage industries more effectively and operate services more efficiently at a lower cost to the public.

In 1993, the amendment to the Public Corporations Act, 1992 (PCA) created the Presidential Parastatal Sector Reform Commission (PSRC). The PSRC functions as an agent of the Government, and it was granted responsibility for carrying out policies approved by the Government and overseeing the privatization process through commercialization and privatization of the most significant SOEs, and liquidation of all non-viable SOEs.

PSRC has successfully privatized several SOEs, including Tanzania Telecommunications Company Limited (TTCL), Tanzania Cigarette Company (TCC), The National Bank of Commerce (NBC) and the National Micro-finance Bank (NMB). The privatization of these SOEs took several forms, including either sale or transfer of shares or leasing or concessioning to operators. Independent regulatory agencies have been created to monitor the privatized companies. For example, the Surface and Marine Transport Authority (SUMATRA) was created under the Surface and Marine Transport Authority Act, 2001. SUMATRA is empowered to regulate privatized companies and concessions created under the Tanzania Ports Authority (TPA) and the Tanzania Railway Corporation (TRC).

The emergence and development of public-private partnerships (PPPs or P3s) occurred during the period of privatization of SOEs. The development of PPPs was part of the privatization plan for some of the utility SOEs, and SOE infrastructure assets were leased or concessioned to private operators. There was no clear demarcation between privatization and P3s in Tanzania since some of the technicalities used in privatizing SOEs were similar to

technicalities used in forming PPPs. For example, in the case of the TPA, it involved the private sector by leasing its container services terminal for ten years to a private sector operator known as the Tanzania International Container Services Limited (TICTS).

In Tanzania, PPPs take a variety of forms but generally involve a contractual relationship between a public entity and a private party (concessionaire) for provisions of public service or for developing public infrastructure. PPP forms include:

- *Contracting Out*: A public agency contracts with an external private company.
- *Franchising/Concession*: A private partnership takes over responsibility for operating a service and collecting charges and possibly for funding new investments in fixed assets.
- *Affermage*: The public authority controls the construction and owns the fixed assets, but contracts out operations, maintenance and collecting service charges.
- *Leasing*: Making use of equipment/assets without purchasing but paying a lease.
- *Privatization*: Public service is entirely sold to a private partner.
- *Management contract*: Private organization takes over responsibility for managing a service to a specified standard by using staff, equipment, etc., of the public authority.
- *Build Own and Operate* (BOO): Partnership between public and private sectors whereby the private firm may build, own and operate the asset/service.
- *Build Operate and Transfer* (BOT): Same as BOO but the asset/service will be transferred to the public sector after a period of time.
- *Management Buyout* (MBO): The management of well run function of a public body negotiates the purchase of that function and becomes a private venture.
- *Co-operatives*: Self-governing voluntary organizations designed to serve the interests of their members, working in partnership with public authorities.

Other forms of cooperation between the State and the private sector are production sharing agreements and mining development agreements[3] and special export processing zones created to promote export growth internationally.

There is no strict PPP classification that can be made, because PPP classification depends on the type of services, the nature and strengths of the

3. Production sharing agreements are the main source of PPP in the petroleum industry, where the public corporation Tanzania Petroleum Development Corporation enters in to a joint venture with the private sector for the exploration and production of petroleum.

partners and the objectives of the PPP. Partnerships are basically institutional arrangements, which constitute rules defining the relationships that govern the partnerships, roles, responsibilities and accountability mechanisms (formal or implied). The overall aim of PPPs is to meet public needs that would not be met without joint efforts.

The Government faces numerous challenges in relation to public infrastructure, including maintenance and operational obligations. There is an ongoing need for new infrastructure and upgrading and/or rehabilitating existing infrastructure in order to achieve the effective delivery of public services. The Government, in recognizing the gap between needs and financial resources, has acknowledged the need to facilitate provisions of infrastructure through PPPs.

PPPs could create favourable conditions to attract investors into the Tanzanian economy. They are a good tool for constructing new or reconstructing obsolete infrastructure (including in hard-to-access areas), and they provide an effective way to use state property, which cannot be privately owned. As a result of the promulgation of the Tanzania Investment Act 1997 (TIA), the creation of the Tanzanian Investment Centre (TIC) and its efforts to attract local and foreign investors, Tanzania has created a favourable environment for the development of PPPs in the key economic sectors. Notwithstanding the positive changes in the PPP regime, however, the current legal and regulatory frameworks still present a number of difficulties for those structuring and participating in PPP transactions.

This chapter describes the current state of the PPP arrangements in the Tanzanian market and gives an overview of some of the difficulties that are currently present in the legal and regulatory environment in relation to the creation of PPPs. It is intended to familiarize investors with the key concerns that may arise in the legal and regulatory framework of Tanzania. It also examines the role of the TIA in attracting foreign and local investments in PPPs. Lastly, this chapter documents current legislation and procedures that will be applicable to newly formed PPP entities, and it explores possible future developments for PPPs.

Concession Agreements

Concessions/leases are one of the most common forms of PPP schemes in Tanzania, and they have been used to promote private participation in sectors such railway and water transport, and in the water supply and sewerage service industries. Most of the concession agreements awarded to the private sector have been awarded by the PSRC, which represents the Government. Concession agreements are entered into between government agencies (grantor), who are usually operators of specific services, and a private sector partner who is granted a concession to operator the service or facility for a specified term. The concessionaire/investor bears the responsibility of operating and financing either the construction or rehabilitation of the infrastructure.

Parties to the Concession Agreement

Parties to a concession are usually the grantor and the concessionaire, and in Tanzania the grantor is represented by the local government authority and either the Ministry responsible for the local authority or by CHC (formerly PSRC). The concessionaire is a company incorporated under the laws of Tanzania, whose shareholders include the strategic investor (usually a consortium) that is the successful bidder. In more complex PPP projects the concession agreement may also include other Ministries or local authorities as guarantors.

Terms and Conditions of the Concession Agreement

A model concession agreement is provided by the Ministry of Energy and Minerals for investors interested in entering into production sharing agreements with TPDC. However, there is no standard concession agreement that is applicable to all PPP transactions.

Each concession agreement includes the following mandatory terms and conditions

- The scope of services of the concessionaire/lessee
- The obligations of the parties during the concession period
- Ownership of assets and land
- Performance targets
- The tariffs that the concessionaire can charge
- A concession fee
- A performance bond

Concession Fee and Period

Under the concession agreement, the concessionaire is obliged to pay the grantor a fixed annual fee in consideration for the grant of the concession. Other fees are payable depending on the type of project covered by the concession. The grantor has a right under the agreement to impose a financial penalty in the event of failure to pay the concession fee.

Assignment of Rights and Transfer Obligations

Assignment of the project company's rights and obligations under the concession agreement is subject to prior approval, in writing, by one of the parties – usually the concessionaire/investor, However, in most concession agreements the grantor has the right to assign its responsibilities under the agreement to another government agency, a private enterprise or another entity.

1.1. Market Context

1.1.1 Current Status

The private sector in Tanzania is still in its infancy. It is relatively very small in size and capital base, and participants in the private sector still lack adequate experience, skills, knowledge and the exposure needed to provide and expand the quantities and qualities of goods and services in a sustainable manner. After independence in 1961, Tanzania embarked on socialist policies. In the mid-1980s, the country started changing its socialist ideologies to a more market-based, and therefore private-sector-led economy.

Options to address the challenges above and to sustain progressive socio-economic development are to enhance the role of both the public and private sectors in owning, financing, managing and operating the production and distribution of goods and services as well as to encourage the private sector to undertake investments in infrastructure development. Consequently, PPPs have been identified as a viable means to effectively address financial constraints, management and maintenance of public sector projects, and they should increasingly be viewed as a mechanism to provide efficient state and local government authorities' functions on a cost effective and sustainable basis.

Furthermore, PPPs should enable the Government to streamline its responsibilities for the delivery of socio-economic facilities, thus ensuring efficiency, accountability, quality of service and access. Under PPPs, the public sector is publicly accountable and responsible for ensuring that the needs of different sections of the population are treated equitably. The public sector has the responsibility to ensure that any contract awarded to the private sector provides optimum value for the taxpayers' money. The private sector on the other hand must make sure that it does not create a private monopoly situation, and the private sector is accountable to its clients, shareholders, and owners.

The PSRC, which was responsible for the creation of several major PPPs in Tanzania, vested all its remaining tasks to the Consolidated Holding Corporation (CHC) in November 2007, when its legal tenure expired on 31 December 2007. Some of the notable PPP projects which have been implemented in Tanzania by PSRC include the following:

- Rehabilitation of the Kilimanjaro International Airport (KIA) and its estate which were concessioned to Kilimanjaro Airports Development Company (KADCO) for twenty-five years in November 1998.
- The leasing of the Tanzania Harbours Authority's container terminal services to a private sector consortium known as the Tanzania International Container Services Limited for a term of ten years.

- A ten year lease granted by the Government to City Water Services to act as an operator and take over the management and operations of DAWASA in relation to water supply to the City of Dar-es-Salaam.
- The licensing of two independent power producers (IPP) – Independent Power Tanzania Limited (IPTL) and Songas Limited – in order to allow private participation in power generation.
- A management contract entered into with NET Group for the management of the operations of Tanzania Electric Supply Company prior to its privatization.
- Recently the state-owned Tanzania Railway Corporation (TRC) entered into a lease agreement with India's RITES Company Ltd (RITES) under a policy of privatization and concessioning, whereby the Government retains ownership of the infrastructure assets of TRC but RITES owns 51% of the newly formed company Tanzania Railways Limited. In accordance with the terms of the deal, the entire infrastructure of TRC, including tracks and rolling stock is handed over to RITES for revamp, maintenance, and management for a period of twenty-five years.
- The Government is also currently planning to sell a 49% stake in the state-run Air Tanzania Company Limited to a Chinese firm that will help it purchase nine aircrafts for domestic and international flights.

PPP projects at a regional or municipal level have concentrated mainly on solid waste management and on health service delivery. Local government authorities (LGA) in Arusha,[4] Kigoma,[5] Kisarawe,[6] and Dodoma[7] to name a few, have used PPP in their regions or municipalities as a tool for collecting revenues at markets and bus stands; solid-waste collection and disposal; operation of public toilets; leasing and sale of council properties; procurement of supplies; and in bridges, roads and building construction projects.

There were several conditions imposed on the prospective actors who were intending on entering in PPPs in providing the above services including payment of non-refundable application fees, possession of knowledge, expertise, equipment and capacity to perform the task at hand. Other general conditions for those intending to enter in PPPs include an analysis and breakdown of revenues that one expects to collect, costs involved in revenue collection and amount of revenues to be paid to the municipalities on a monthly basis[8] and the attachment of a certified banker's cheque equivalent to three months' payment of the amount expected to be paid to the LGA per month, which

4. Tanzanian Newspaper, *Mwananchi* (19 May 2005).
5. Tanzanian Newspaper, *Mwanachi* (11 Jun. 2005).
6. Tanzanian Newspaper, *Nipashe* (11 May 2005).
7. *Nipashe, ibid.*
8. The amount should be in line with LGA's Regulations.

is to be retained for a period of the contract period for those who are awarded the tenders/bid etc.

1.1.2 Sector-Specific Aspects

The PPP market in Tanzania tends to concentrate more on economic infrastructure and less on the social infrastructure sector (health, education, waste water treatment). Investment agencies such as the TIC are focused on promoting investment in sectors such as energy, roads and air transport, railways and water transport. Although health care and education play an important role in the development of the country, there is very little government and private sector participation in this area. Schools or educational institutes created are strictly private, and the same applies in health care where many new hospitals are private sector initiatives.

In the economic infrastructure sector, the energy sub-sector currently receives a lot of investment, due to the considerable domestic demand for power, which has risen significantly over the years, and due to ample resources available for power generation (hydro, gas, coal, oil and bio-fuels). Discoveries of hydrocarbons on Songo Songo Island and at Mnazi Bay, have paved the way to development of gas to power projects by Songas Limited and Artumas.

Concessions were introduced by the Government in the 1990s to attract domestic and foreign investment in the construction of roads. Opportunities are available for the construction of roads through a BOT system, and legislation has been enacted[9] to provide the necessary framework for toll roads. Concessions will be granted to the private sector which will have the right to levy and collect user charges. There are private investment opportunities in other transport related sectors such as air, marine and railway. Investors are encouraged to develop the airport infrastructure at airports and to manage them. Concessions have already been granted in the marine sector and in the railway sector for the revamping of rolling stock, and the improvement of the passenger and freight services. Other opportunities available in these areas are for the development of container depots, expansion of railway network through BOT or BOOT schemes, the provision of docking facilities and the supply of ships.

PPP projects in the economic infrastructure sector are possible through sector specific legislation, which provides for either management or concession schemes to facilitate PPP. The key areas that provide PPP opportunities through legislation are: roads and bridges, railway infrastructure, airports and marine transport facilities, power generation and transmission facilities and water supply and sewerage treatment.

9. The Roads Act.

1.2. Legal Context

Application of PPPs in Tanzania is still a relatively new phenomenon, and the country is still undergoing the early stages of legal and regulatory development in this area. Tanzania does not have a single central PPP unit that can guide investors on the implementation and promotion of PPPs. However, the Government is currently undergoing reforms to introduce legal and regulatory frameworks that can adequately develop a systematic approach to the development and implementation of PPPs.

High Government spending in key infrastructure and utilities sectors i.e., transportation, construction, energy and communication in Tanzania visibly underscores the importance of the PPP. However, the policies for health, education and water supply sectors are still not exhaustive. Notwithstanding this increase in Government spending, effective implementation of PPP in Tanzania lacks a clear policy, legal and institutional framework.

1.2.1. Regulatory Framework

The regulatory system of the PPP market in Tanzania is based on regulation at ministerial or local government level, and on regulation based on sector legislation.

At the ministerial/local government level, several Ministries, Government departments, local authorities and independent Government agencies are involved in PPP transactions. Such include the following:

(i) Ministry of Finance
(ii) Ministry of Industry, Trade and Marketing
(iii) Ministry of Infrastructure Development
(iv) Consolidated Holdings Corporation
(v) National Construction Council
(vi) Tanzania Roads Agency (TANROADS)
(vii) National Development Corporation (NDC)
(viii) Tanzania Petroleum Development Corporation.

Independent regulators which have been set up to promote and monitor PPP transactions according to sector specific legislation include the Energy and Water Utilities Regulatory Authority (EWURA), the Surface and Marine Transport Authority (SUMATRA); the Tanzania Civil Aviation Authority (TCAA); the Tanzania Communication Regulatory Authority (TCRA); the Public Procurement Regulatory Authority (PPRA); the Fair Competition Commission (FCC) and the Public Procurement Appeal Authority (PPAA).

In the absence of specific legislation that provides the legal framework for creating PPPs, Government institutions, corporations and local authorities

such as the Tanzania Petroleum Development Corporation, the Tanzania Ports Act, and the Dar es Salaam Water and Sewerage Authority, have been implementing PPP undertakings either by virtue of the laws establishing them. The public corporation Reli Asset Holding Corporation (RAHCO) is an example of an institution which has relied on its enabling legislation in order to enter into a PPP arrangement. The Corporation was established under the Railways Act, Cap. 170 [Revised Edition 2002], to develop, promote and manage and on behalf of the Government, rolling stock and rail infrastructure assets, is also empowered to delegates its powers to operate the rail infrastructure by entering into agreements by means of concessions, joint ventures or PPPs.

1.2.2. Legal Framework

The general legal framework at the national level for PPP projects includes:

(i) the Companies Act 2002;
(ii) the Tanzania Investment Act Cap. 38;
(iii) the Foreign Exchange Act Cap. 271;
(iv) the Government Loans, Guarantees and Grants Act No. 30 of 1974;
(v) the Fair Competition Act 2003;
(vi) the Land Act 1999 and the Land (Amendment) Act, 2004;
(vii) the Village Land Act 1999;
(viii) the Income Tax Act, 2004; and
(ix) the Environmental Management Act, 2004.

The Companies Act 2002, the Tanzania Investment Act and the Income Tax Act provide the general legal framework for undertaking business activities in Tanzania and encompass those activities related to the implementation of concessions and other PPP projects. Laws such as the Land Act, the Village Land Act and the Environmental Management Act set out, among other things, conditions for: allocating land (including water, and forest); taking security interests in moveable and immoveable property; constructing, developing and operating real estate, obtaining planning, zoning and other permits and licenses; transferring and registering title to immoveable property and complying with applicable environmental conditions. The Foreign Exchange Act sets out the exchange controls imposed by the Bank of Tanzania, such as the creation of offshore bank accounts, and investment in foreign securities and real estate, whereas the Government Loans, Guarantees and Grants Act empowers the Ministry of Finance to provide government guarantees to local government authorities or public corporations involved in PPP projects.

1.2.3. Investment Legislation and PPPs

Foreign or local investment, unless specifically provided for in sector-specific legislation, is governed by the TIA. The TIA established the TIC to act as the primary agency for the Government in attracting local and foreign investors and in promoting and facilitating investment in Tanzania. The TIC's function is also to actively strengthen the business and investment environment through public-private dialogues aimed at increasing local and foreign investment, and hence leading to economic growth.

Although investment protection measures such as protection of investment assets from expropriation, transferability of foreign currency without foreign exchange controls, and agreement to rely on bilateral or multilateral agreements in the event of investor-Government disputes existed under the former National Investment(Promotion and Protection) Act, the TIA is the first compact investment legislation through which the TIC seeks to attract foreign investment, by creating a one stop shop that aims at initiating and supporting the investment climate in the country for both local and foreign investors. The TIC regulates the following areas:

(i) the identification of investment sites, estates or land together with associated facilities of any sites, estates or land for the purposes of investors and investments in general;
(ii) the procurement of all necessary permits, license approvals, consents, authorizations, registrations and other matters required by the law for setting up and operate an investment;
(iii) the provision, development, construction, maintenance and administration of investment sites, estates or land together with associated facilities of those sites, estates, land; and
(iv) the carrying out and supporting of local investment promotion activities which are necessary to encourage and facilitate increased local investments, including entrepreneurial development programmes;

The TIC also gathers and distributes information about investment opportunities and sources of investment capital, and advises investors, upon request, on the availability, choice or suitability of partners in joint-venture projects.

In its efforts to solidify the public-private dialogue, the TIC is in constant consultation with Government institutions and agencies. It identifies potential investment sites, estates, or land for the purposes of investors and investments in general, and it also provides, develops and creates, subject to relevant laws, export processing zones. Furthermore, the TIC assists all investors (foreign or local) to obtain all necessary permits, licenses, approvals, consents, authorizations, registrations and other matters required by law to enable an investor

to set up and operate an investment, and to enable certificates of incentive issued by the TIC to have full effect.

Businesses covered under the provisions of the TIA enjoy a full range of benefits such as guarantees unconditional transferability in freely convertible currency of: (i) dividends attributable to the investment 'through any authorized dealer bank'; (ii) payments for loan servicing if a foreign loan has been obtained; (iii) royalties, fees and charges in respect of any technology transfer agreement registered under the TIA; (iv) the remittance of proceeds in the event of sale or liquidation of the business enterprise and (v) payments of emoluments and other benefits to foreign personnel employed in Tanzania in connection with the business enterprise. Furthermore, the TIA guarantees that a business shall not be nationalized or expropriated by the Government, and there shall be not be any acquisition by the State, whether wholly or in part, of the business enterprise. Acquisition or expropriation may be allowed if the business is afforded due process of the law, under which the business is entitled to fair, adequate and prompt compensation, and the right to have the Courts or an arbitration tribunal determine the right to compensation and the amount of compensation.

2. LOCAL LEGAL ISSUES

2.1. Procurement Restrictions

In Tanzania, the grantor will be subject to procurement requirements set out under the Public Procurement Act, 2004 and the Local Government (Procurement of Goods and Works) Regulations, 2005 (the Local Government Procurement Regulations). These pieces of legislation make provisions for the regulation and procurement of public goods and services and apply to all procurements done by a public body, to all local government authorities and to non-government entities that undertake procurement funded/financed from specific public finances.

The Local Government Procurement Regulations are extensive and provide for the method of procurement and general procedures of procurements, eligible suppliers and contractors, and approval of procurement by the approving authority. The solicitation of tenders and applications for pre-quality, submission of tenders and the receipt of tenders and tender openings are also provided for under the Regulations.

The Regulations provide for the establishment in each district or municipal council, of a Council Tender Board, whose duties include receiving and approving the issue of tenders and receiving and approving applications for procurement of goods, works or services by departments of the local government authority.

Provisions relating to international and national competitive tendering are included in the Regulations as well as provisions that relate to single source procurement of goods and direct contracting of works. The Regulations also deal with the prohibition of fraud and corrupts practices, improper inducement, and other prohibited practices during the tender process.

The Public Procurement Act, 2004, establishes the Public Procurement Regulatory Authority whose functions include monitoring compliance of public entities, setting standards for the public procurement systems in Tanzania and monitoring the award and implementation of public contracts.

The Act makes provisions on who can bid for the procurement of public goods, works or services. In order to participate in procurement proceedings, suppliers, contractors and consultants have to qualify by meeting the criteria set by the procuring entity (i.e., a public body or any other body or unit mandated by the Government to carry out public functions) and by the approving authority for those particular procurement proceedings. Local suppliers, contractors and consultants must also satisfy all relevant requirements for registration with the appropriate current professional bodies in Tanzania. Foreign suppliers, contractors and consultants wishing to participate are exempted from initial registration but must register with the appropriate professional body and provide evidence of such registration, if they have been selected as the best ranked proposal.

The Act makes provision for the methods of procurement to be used by the procuring entity, depending on the type and value of the procurement. The criteria for selection of consultants, the procedures for the receipt and opening of the tender documents and for the award of the contract are also highlighted in the Act.

The criteria for the evaluation of the tendering entity is set out in the tender documents, and the both the procuring entity and the tender board will evaluate the candidates participating in the procurement proceedings in order to determine whether the candidate has the capability and resources for carrying out the contract as offered in the tender.

Suppliers, contractors and consultants are allowed to participate in procurement proceedings regardless of their nationality, however national preference will be given under the Act, where the procuring entity has limited participation in the procurement proceedings on the basis of nationality. The procurement entity shall also, when procuring goods, works or services by means of international or national tendering, grant a margin of preference for certain goods manufactured, mined, extracted or grown in Tanzania, for works by Tanzanian contractors and for services provided by Tanzanian consultants. However this preference must be clearly stated in the tender document.

Tanzanian contractors or consultants that are eligible to be granted a margin of preference must meet certain criteria provided in the Act in that they must be incorporated or registered in Tanzania, at least 50% of the authorized

capital must be owned by either the Government of citizens in Tanzania, they must not subcontract more than 10% of the contract price to foreign contractors or consultants, and they must not may any arrangements for the payment of any major part of the net profits to non-citizens. The Act also encourages foreign firms to team up with Tanzanian contractors, suppliers or consultants in the form of joint venture or sub-contracting arrangements, in the tender process and execution of the contract.

The provision of a form of tender security such as a guarantee or a performance bond, is also stipulated in the Act, and where the procuring entity requires suppliers, contractors or consultants submitting tenders to provide such security, the requirement shall apply equally to all.

2.2. Third Party Rights to Challenge a Project

Discussion to be provided in future updates.

2.3. Ultra Vires

It is important to have clarity as to which Government entities or departments need to be involved in the approval process for the project, the approval chain and process. In particular, infrastructure projects may require the involvement of several public authorities, at various levels of government, possibly central, provincial and local. Authority to award government contracts may be centralized in a different authority from the authority with operational duties to deliver infrastructure projects. Also, any government support or funding obligations may need approval from a different authority, such as the Ministry of Finance or economic coordination.

2.3.1. Private Companies

The Companies Act 2002 sets out the powers and rights of a company and in addition it sets out the requirements for an individual or a group of individuals who represent the company to third parties. If a company wishes to act in a way that it is not authorized to do, or which is not a part of its stated objective, then it must alter the company's memorandum in order to bring the intended action into its authorized remit. In theory this procedure is applicable to both private and public limited companies and failure to follow these statutory procedures will render company activity ultra vires. However, as will have been noted from the main publication article, the international legal developments and practice in this area, perhaps most demonstrable from the EU company law directive, has greatly undermined the strictness in which the

ultra vires doctrine is being applied. This trend has equally influenced the laws and practice in Tanzania so that, for example, should an officer of a company in Tanzania act on behalf of the company without the power so to so, such action can ultimately be ratified by the company giving the officer the authority to act on its behalf.

2.3.2. Public Bodies

All powers bestowed on government entities or local government authorities are provided in their enabling legislation or constitution, to ensure that the entities do not act ultra vires. The doctrine of ultra vires generally applies to the acts of public bodies, whose powers are laid down by statute or legal act. The public body will have power to enter into arrangements only as specified in its constitutive statute. Therefore, contracts entered into by public bodies will only be valid in so far as they relate to functions that the body is authorized, expressly or impliedly, to perform. Each legal system will prescribe the extent to which a public body's powers may vary from the strict construction of its constitutive statute.

This is a particularly difficult issue where several political or governmental entities are involved, since lines of authority may be blurred. The project company will need to assess whether the grantor has the right to undertake the obligations involved in the project and what administrative or legal requirements must be satisfied before the obligations become binding.

2.4. Corporate Law

There are two routes to establish a business presence in Tanzania: (i) by incorporating a Tanzanian limited company (limited by guarantee or shares); or (ii) by obtaining a certificate of compliance in respect of a foreign company. In the latter, the foreign company sets up a branch office in Tanzania. The registration for either process is relatively straightforward. Registration of a Tanzania limited liability company involves lodging of the memorandum and articles of association (in the case of Tanzanian limited liability company), or together with details of the intended registered address of the company, the first directors and company secretary with the Companies Registry. There are no restrictions on the nationality of shareholder or directors, provided a minimum of two shareholders is provided as the first subscribers of the company. The Tanzanian company must have at least two directors and one company secretary. To ensure compliance with reporting requirements it is recommended that company secretaries that are resident in Tanzania be appointed.

In terms of the value of the share capital, there is no minimum share capital figure, however companies are advised that a sufficient sum be used based on