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Indonesian power projects

Ten things to know



Indonesian power projects

01 | Negative Investment List

The so-called Negative Investment List (last revised by Presidential Regulation No. 39 of 2014) imposes maximum limits of foreign ownership for various categories of business activity. Up to 49 per cent foreign ownership is permitted for power generation projects between 1 and 10MW while up to 95 per cent foreign ownership is permitted for power generation projects above 10MW. It is also possible for power generation projects above 10MW to be 100 per cent owned by foreign investors provided that the projects use a public private partnership (PPP) scheme. Power projects below 1MW are reserved for Indonesian entities. A maximum of 95 per cent foreign ownership is also permitted in relation to geothermal drilling.

02 | Geothermal

A major potential source of electricity in Indonesia is geothermal power. In 2014, Indonesia's parliament took a major step forward in developing Indonesia's geothermal resources by passing a new Geothermal Law (Law No. 21 of 2014). Indonesia holds 40 per cent of the world's geothermal reserves, offering huge renewable energy potential. At 330MW, the landmark Sarulla geothermal power project, for which the Final Investment Decision (FID) was made in 2014, is the world's largest geothermal project.

Geothermal activities had previously been defined as mining, leading to a prohibition on any geothermal activities in protected forests or conservation forests. Since more than 80 per cent of Indonesia's geothermal reserves are found in those areas, the old geothermal regime severely restricted exploitation of geothermal energy resources in Indonesia.

The Government of Indonesia development target of 5GW of electricity sourced from geothermal energy by 2025 would require a capital investment of more than US\$20 billion. Local investors are unlikely to have sufficient capital, so international support is needed. With foreign ownership of up to 95 per cent being permitted in the geothermal business, there is a huge opportunity for major foreign investors with the necessary technical capacity.

03 | Procurement methods and tender process

Procurement methods

Pursuant to Law No. 30 of 2009 on the electricity sector, power generators are permitted to sell electricity to entities other than PLN, the state electricity utility, provided the power generators have been allocated a specific business area. However, despite the change in law, most electricity generated in Indonesia is still either self-generation (captive) or sold to PLN.

PLN procures new independent power projects (IPPs) under a number of different strategic programs. The latest programme, which covers the development of power generation in 2015–2019, was set at 35GW under the 2015–2024 Business Plan for the Provision of Electric Power (2015–2024 RUPTL), as approved by the Minister of Energy and Mineral Resources (MEMR). Nearly 30GW of new capacity has been reserved for IPPs, including coal, gas, geothermal and hydro technologies.

Some IPPs are being procured under Indonesia's Public Private Partnership (PPP) programme, pursuant to Presidential Regulation No. 38 of 2015 (PR 38/2015) which replaced Presidential Regulation No. 67 of 2005. The procurement method has a bearing on the type of incentives offered for the projects, including availability of a government guarantee and assistance in land procurement (discussed below).

Tender process

New energy projects can be procured under one of three tender processes – direct appointment, direct selection, and public auction (see MEMR Regulation No. 1 of 2006 on procedures for purchasing electricity and/or lease of grid for power supply in the public interest, as amended by MEMR Regulation No. 4 of 2007, and MEMR Regulation No. 3 of 2015 on procedures for purchasing electricity and the base price for PLN to purchase electricity through direct selection and direct appointment).

Direct selection is limited to (i) mine-mouth, marginal gas and hydro projects, to purchase excess power from mine-mouth, coal, gas and gas machine and hydro power generators, (ii) situations where the local power system is in a critical condition, and (iii) to increase the capacity of existing power generators operating in the same location.

PLN is also obliged to comply with Presidential Regulation No. 54 of 2010 (as lastly amended by Presidential Regulation No. 4 of 2015) on guidelines for Government procurement of goods and services. This imposes obligations regarding public announcements, pre-qualification of bidders, and bid submission and evaluation.

Under the tender methods, the key bid parameter is the price at which generators are willing to sell the electricity generated. The MEMR has issued several regulations on PLN's purchase price for electricity derived from various sources. For instance, the purchase price for hydro power plants with up to 10MW capacity and biomass and biogas power plants is set by the MEMR under relevant regulations,

without scope for negotiation. While for geothermal power plants, the relevant MEMR regulation only stipulates a ceiling price for PLN to purchase electricity.

Under the public tender process, the request for proposals issued by PLN generally contains a draft form of Power Purchase Agreement (PPA) and other relevant project agreements such as a draft guarantee agreement (if the project is being tendered under a PPP programme). Bidders are often able to make submissions on the PPA (and other drafts provided by PLN) form before submission of their bids. The winning bidder is expected to execute the PPA within three to four months of the date PLN confirms the winning bid in its letter of intent.

The MEMR must approve the price payable for the electricity.

04 | Power Purchase Agreement (PPA)

PLN does not use a standard form PPA. Rather, the form of the PPA evolves from project to project, with most projects containing a generally similar risk allocation. Developers and lenders have become familiar and to some extent comfortable with the typical risk features of the PPA, which include:

- take-or-pay
- force majeure and change in law relief
- termination payments for PLN default and political force majeure
- international arbitration
- assignment to lenders being permitted
- agreed form of direct agreement between lenders and PLN.

Many terms of the PPA have become fairly standard and non-negotiable. However, key areas for negotiation are:

- components of termination payment
- deemed commissioning (and any grace period given to PLN)
- deemed dispatch payments (and any grace period given to PLN)
- triggering events for cost increases (including change in law)
- fuel cost pass-through.

05 | Land

Land acquisition is an important issue for power projects in Indonesia. PLN generally expects developers to acquire all of the land needed for the plant site and the transmission lines needed to connect the plant to the nearest substation. It is common for the transmission corridor to be 20 to 40 kilometres long. PLN and lenders generally expect this land to be obtained and appropriate legal rights over that land to be granted by the financial closing date. The process of land acquisition can often be one of the longest lead items in the development of an Indonesian power project.

Realising the importance of land acquisition, Law No. 2 of 2012 on Land Procurement in the Public Interest provides that for certain types of projects in the public interest, the Government can procure the land to be used in the project. Electricity infrastructure is one such category of project. PR 38/2015 also provides that the Government can procure the land for certain projects using a PPP scheme.

In recent projects, PLN has indicated a greater involvement with the land acquisition process. For example, in the Java 7 project PLN intends to acquire the land for the project, in return for an equity stake in the IPP.

Indonesian law broadly recognises two categories of land rights: unregistered land and registered land. Numerous forms of unregistered land exist, the most common being *adat* (or native title) land. Given that native title land is unregistered, it is often difficult to ascertain the identity of the landowners. Disputes with respect to transfers of communally held land are particularly common, where one party has purported to represent the relevant community and signed land transfer documents. Accordingly, it will be critical to establish who owns the *adat* land and who can legitimately and lawfully relinquish rights over it so that it can be converted into registered land.

The following are the relevant forms of registered land:

- Right of Ownership (*Hak Milik*). This is the closest form of land title to the common law concept of freehold land. A Right of Ownership may be held by Indonesian nationals only, therefore this will not be possible for a foreign-owned project company.
- Right of Building (*Hak Guna Bangunan* or HGB). A Right of Building is for a term of 30 years, and may be held by a company, including a foreign-owned project company. This is the most popular form of land ownership for project companies.

- Right of Use (*Hak Pakai*). A Right of Use is for a term of 20 years, and may be held by a company, including foreign-owned project companies.

As foreign-owned companies cannot hold unregistered land or Right of Ownership, land which is unregistered or in the form of Right of Ownership must first be converted into either a Right of Building or a Right of Use. This can sometimes be a lengthy (and expensive) process.

06 | Forestry

The location of a project is a key consideration in Indonesia. Not only does the developer have to consider the availability of nearby substations and transmission facilities, but it also needs to consider the proximity of forests. Renewable energy projects such as geothermal and hydro projects are often located in forests, raising special considerations for developers.

Indonesian law distinguishes between conservation forests, protected forests and production forests. Production forests are forest areas whose main function is to produce wood products. Power projects are permitted in production forests and, since 2010, are also permitted in protected forests (under Government Regulation No. 24 of 2010 regarding Utilisation of Forest Areas). Project developers, however, must obtain a Forest Borrow Permit (*Izin Pinjam Pakai*) from the Ministry of Forestry to ‘borrow’ the forest area for this purpose. A Forest Borrow Permit is only issued for a single purpose, so an application must be submitted to the Ministry of Forestry to diversify the use of the forest area.

The application process for a Forest Borrow Permit is complicated, requiring (among other things) a Letter of Recommendation from the Provincial Governor. We are aware of numerous instances where the issue of a Forest Borrow Permit has been delayed or blocked, due to the reluctance (or refusal) of an authority to issue a Letter of Recommendation, and there is a significant backlog of Forest Borrow Permit applications at the Ministry of Forestry.

Forest Borrow Permit applicants must also comply with land compensation requirements. The application for a Forest Borrow Permit will require the applicant to provide land compensation in certain provinces, while in other provinces the applicant will be required to pay ‘non-tax state revenues’ and commit to reforestation and rehabilitation.

Forest Borrow Permits are usually granted for a period of 20 years and may be extended only with the consent of the Ministry of Forestry. Note that this period is less than the term of a typical PPA at 25 or 30 years. They provide non-exclusive rights to carry out permitted activities in the forest but do not allow the developer to take title in the land. The permit is revocable in situations where the permit holder has breached conditions relating to the permit. Such conditions

typically include obligations to replant forest where it has been cut, to protect the forest, and to pay fees for utilisation of the forest land.

07 | Permits

An Indonesian power project requires an extensive list of permits from a variety of central and regional government departments and ministries. Developers should be mindful of the extensive application and processing time associated with permitting.

The main permits that a power project developer is required to obtain are:

- Registration with the Investment Coordinating Board (BKPM) for the establishment of the project company and Investment Principle License.
- Business Licence (*Izin Usaha*), which is issued by the BKPM when or immediately before the project reaches commercial operation.
- Environmental Permit (*Izin Lingkungan*), which includes, among others, approval of environmental impact assessments (*Analisis Mengenai Dampak Lingkungan* or AMDAL).
- Location Permit (*Izin Lokasi*), which allows the company to procure the land required for the project from a third party (by way of sale and purchase or relinquishment) or from the state, and to develop the project on the land.
- Electricity Business License (*Izin Usaha Penyediaan Tenaga Listrik* or IUPTL).
- Certificate of Operational Worthiness (*Sertifikat Laik Operasi* or SLO).

If a project company seeks finance from the international lending community, it is likely to have to comply with established environmental standards such as the Equator Principles or the IFC environmental standards. These raise requirements beyond the remit of the AMDAL.

08 | Construction

Under Government Regulation No. 29 of 2000 regarding the Implementation of Construction Services (as amended by Government Regulation No. 59 of 2010), the project company is required to carry out a public tender for onshore construction work. There are few exceptions to the general rule; one such exception is where the project involves complex works using new technology where there is only one construction service provider able to supply such technology. A difficulty with this regulation is that it does not address the situation where a shareholder of the project company intends to carry out the onshore construction works.

Construction contracts in Indonesia are often ‘split’ to maximise the tax benefits for the project company. An engineering, procurement and construction (EPC) contract is typically split into an offshore design and equipment supply contract, an onshore civil erection, installation and testing contract, and a ‘wrap’ whereby the onshore and offshore contractors confirm certain performance guarantees and joint and several liability. Project developers should seek Indonesian tax advice when structuring their construction contracts in this manner.

The Indonesian local content regulation (Ministry of Industry Regulation No. 54 of 2012 on guidelines for utilisation of domestic goods and or services for development of electricity infrastructure) requires the project company to use Indonesian goods and services. There are some exceptions, for example, where meeting those requirements is not as favourable to the project company as procuring the goods and services from overseas, taking into account price, quantity, reliability and so on.

Developers should also check relevant Ministry of Industry regulations which may impose additional requirements on the ownership of the construction company. For example, Ministry of Industry Regulation No. 54 of 2012 states that construction of hydro projects smaller than 135MW should be undertaken and led by a national company (i.e. a company wholly Indonesian-owned).

09 | Government guarantees

In Indonesia the retail price of electricity is below PLN’s average cost of generation, leaving PLN with a deficit. The Ministry of Finance (MoF) provides funding to PLN to bridge the gap, which is referred to as the Public Service Obligation (PSO). Given that the PSO is critical to PLN’s solvency, developers and lenders have in the past sought confirmation from the Government that the PSO will continue to be paid, so that PLN will be in a position to meet its commitments under the PPAs.

In addition to the PSO, there are two other types of Government guarantee applicable to power plant projects under PPP schemes, namely, a Business Viability Guarantee Letter (BVGL) issued by the MoF and a Guarantee Agreement issued by the Indonesian Infrastructure Guarantee Fund (IIGF). The IIGF was established by the Indonesian Government in 2009 to provide guarantees for Government contracting agencies’ obligations under PPP infrastructure projects, some of which are power projects. The 2,000MW Central Java project is a notable exception, being issued with the first IIGF guarantee in 2011 (alongside a MoF guarantee).

The BVGL is issued by the MoF and addressed to the project companies in the PPP schemes under the framework of MoF Regulation No. 173/PMK.011/2014 (Regulation 173/2014) and covers the risk of non-payment and/or termination of

the agreement. The BVGL may be granted for the period from pre-construction to construction and/or part or all of the operation period.

The BVGL should be construed as a form of support undertaking. It is a mechanism to ensure that the MoF funds PLN so that PLN can fulfil its payment obligations to the IPP. Under Regulation 173/2014, in the event of non-payment and/or termination, the project company is required to submit the claim for the benefit of BVGL through PLN. Although project companies do not have direct recourse to the MoF under the BVGL, under the Indonesian Civil Code, the MoF support letter likely creates a primary legal obligation on the MoF to procure performance by PLN. If the MoF fails to do so, it may be liable for payment of damages to the project company.

The BVGL is not automatically granted to project companies and, therefore, projects wishing to benefit from the guarantee are subject to an application process. The BVGL will be issued after signing of the PPA. Regulation 173/2014 requires that the project benefiting from the BVGL must achieve financial close within 12 months from the date of issue of the BVGL. However, this deadline is extended to 48 months for geothermal projects.

The Guarantee Agreement is executed between the IIGF as the guarantor and the project company as the beneficiary, on or after the signing of the PPA. The Guarantee Agreement is provided under the framework of Presidential Regulation No. 78 of 2010. As in the case of BVGL, the Guarantee Agreement is also subject to an application process submitted by PLN. The Guarantee will cover certain PLN obligations that would adversely affect the investment of the project company. Unlike the BVGL, the project company as the beneficiary may directly claim the benefit under the Guarantee Agreement to the IIGF.

10 | Financing and taking security

Domestic and regional banks are taking a more active role in financing Indonesian power projects. The financing of the Banten 660MW coal-fired project in 2013 is a good example of this. This was the first project to be financed without a Government guarantee.

However, Indonesian power projects have largely been financed by international lenders with strong support from export credit agencies like JBIC and the Korea Export Import Bank. The extended political risk guarantee (EPRG) product offered by JBIC and similar products offered by other export credit agencies have been instrumental in encouraging commercial lending in Indonesia. These products cover the political risks associated with breach of contract by Government parties, expropriation/nationalisation, political violence, and currency non-convertibility.

In contrast to domestic or regional banks, the international lenders have the advantage of access to a deeper liquidity pool and can offer longer tenors and cheaper debt, but have the disadvantage of being more risk adverse and tend to carry out more detailed due diligence and impose more extensive lending conditions.

An important issue for the choice of lenders is the availability of the Government guarantee. To date, the Government guarantee has been essential to the availability of export credit agency finance and cover.

Foreign investment companies must satisfy the debt-to-equity ratios set by Indonesia's Investment Coordinating Board (BKPM) on a case-by-case basis.

The most common forms of security granted in the context of a power project in Indonesia are:

- A pledge or fiduciary security of the shares of the project company.
- Fiduciary security over fixed assets and insurance (with some limitations).
- Foreign law based account charges on offshore bank accounts.
- Step-in rights with respect to contracts entered into by the project company, known as conditional novation agreements. Such rights are not a form of security under Indonesian law and fall short of a 'fiduciary security'. Instead, they constitute a right on the part of the financier to take over the position of the project company if it is unable to pay (for example, its EPC contractor).
- A corporate guarantee. While this is not a form of security, it is common practice for the parent of a project company to provide a corporate guarantee as part of the security package.

Once land is acquired by the project company and is registered in its name, security right over land and buildings (*Hak Tanggungan*) is also usually established in favour of the lenders. Fiduciary security and *Hak Tanggungan* granted by Indonesian companies must be registered at the Fiduciary Registration Office and the relevant Land Office, respectively, in order to give the security holder priority over other creditors.

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📍 Our office locations

Contacts

If you would like further information please contact:

Bangkok

Somboon Kitiyansub

Partner

Tel +662 205 8509

somboon.kitiyansub@nortonrosefulbright.com

Beijing

Tom Luckcock

Partner

Tel +86 (10) 6535 3135

tom.luckcock@nortonrosefulbright.com

Hong Kong

Ben Smith

Partner

Tel +852 2283 1096

ben.smith@nortonrosefulbright.com

Jakarta

Benny Bernarto

Partner

Susandarini & Partners*

Tel +62 21 2924 5003

benny.bernarto@nortonrosefulbright.com

Nadia Soraya

Partner

Susandarini & Partners*

Tel +62 21 2924 5005

nadia.soraya@nortonrosefulbright.com

Shamim Razavi

Senior Foreign Counsel

Susandarini & Partners*

Tel +62 21 2924 5009

shamim.razavi@nortonrosefulbright.com

Melbourne

James Morgan-Payler

Partner

Tel +61 3 8686 6503

james.morgan-payler@nortonrosefulbright.com

Perth

Liz Allnutt

Partner

Tel +61 8 6212 3214

liz.allnutt@nortonrosefulbright.com

Singapore

Jeff Smith

Partner

Tel +65 6309 5312

jeff.smith@nortonrosefulbright.com

Nick Merritt

Partner

Tel +65 6309 5318

nick.merritt@nortonrosefulbright.com

Vincent Dwyer

Partner

Tel +65 6309 5458

vincent.dwyer@nortonrosefulbright.com

Nicola Davies

Partner

Tel +65 6309 5314

nicola.davies@nortonrosefulbright.com

Laurie Pearson

Of Counsel

Tel +65 6309 5391

laurie.pearson@nortonrosefulbright.com

Sydney

Simon Currie

Global head of energy

Tel +61 2 9330 8236

simon.currie@nortonrosefulbright.com

Chris Redden

Partner

Tel +61 2 9330 8435

chris.redden@nortonrosefulbright.com

Mark Waddell

Partner

Tel +61 2 9330 8687

mark.waddell@nortonrosefulbright.com

Tokyo

George Gibson

Partner

Tel +81 3 5218 6823

george.gibson@nortonrosefulbright.com

* Susandarini & Partners in association with
Norton Rose Fulbright Australia

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