

FINAL DRAFT

SAFEGUARDING WATER CONTRACTS IN INDONESIA

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ABSTRACT

Due to financial and technological reasons, water undertakings are often being conducted by large scale Multi National Corporations (MNC). Governments often positioned Regional Authorities as a regulator to these MNCs, and at the same time engaged in water contracts with them through State Owned Enterprise (SOE). However, the relationship between Water MNC and Governments is asymmetrical as MNCs can move their assets overnight, transfer their ownership to third parties, seek various means of redress through bilateral, regional or international investment treaties and avoid confiscation by reallocating their assets. These are often done by hiding behind multiple jurisdictions enjoyed either by their parent companies, subsidiaries or shareholders.

The positions of Governments are the opposite as they do not have the flexibilities enjoyed by MNCs. This paper attempts to prescribe issues that need to be highlighted in safeguarding water contracts in Indonesia.

The first part discusses the legal relationship between institutions involved in a water undertaking. The second part listed down regulatory mechanisms in Indonesian context, more specific towards the impact of Constitutional Court's review of the Water Law (2004). The third part of the paper examines the provisions existing normally in water contracts between a local subsidiary of MNC and regional authorities and presents a point of view in drafting the clauses.

Keywords:

water, environment, privatisation, public service participation, investment, multi national company, infrastructure, human rights, indonesia, civil society, corporate social responsibility, constitution

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I. Background

a. Purpose of the article

Due to financial and technological reasons, water undertakings are often being conducted by Multi National Corporations (MNC). Governments often positioned Regional Authorities as a regulator to these MNCs, and at the same time engaged in water contracts with them through State Owned Enterprise (SOE). However, the relationship between Water MNC and Governments is asymmetrical as MNCs can move their assets overnight, transfer their ownership to third parties, seek various means of redress through bilateral, regional or international investment treaties and avoid confiscation by reallocating their assets. These are often done by hiding behind multiple jurisdictions enjoyed either by their parent companies, subsidiaries or shareholders.

The positions of Governments are the opposite as they do not have the flexibilities enjoyed by MNCs. This paper attempts to prescribe guides that need to be highlighted when signing a water provision contract with MNCs. The first part addresses the legal nature of MNC; the legal relationship between consumer, regional governments, local water companies and its parent company; the legal obligation imposed by state due to international water norms and asymmetries under international law in government-MNC relation.

Second part of the paper listed down regulatory mechanisms in Indonesian context, more specific towards the impact of Constitutional Court's review of the Water Law (2004). It discusses the issues that should be addresses in the implementing regulation of the Water Law including regulation to water companies (share ownership, minimum equity) and regulation toward water undertakings (tender, compensation to prior users, public consultation) and identifies which norms should be regulated in which level in the hierarchy of laws.

The third part of the paper examines the provisions existing normally in water contracts between a local subsidiary of MNC and regional authorities and presents a point of view in drafting the clauses. This part of the paper discusses which choice of law and forum the parties should make, rights and obligations in emergency situations and in drafting the "terms of agreement". This analysis is put under the context of asymmetrical relationship between MNC and governments in water undertakings.

b. Water Law in Indonesia

i. Water rights under the Constitution

Water rights are regulated through two different provisions on the Constitution. The “right to water” is regulated through article 28 of the Constitution and the “right to exploit water” is regulated through Article 33.

The “right to water” is mentioned only implicitly by the Constitution. It is deduced from (1) the right of children to develop and to be nurtured, (2) the right toward the fulfilment of basic needs, (3) the right to a life of well-being in body and mind and to enjoy a good and healthy environment, (4) the right to obtain social security, and (5) the right to cultural identities and the acknowledgment on the rights of traditional communities under Article 28.¹

As an economical good, the “right to exploit water” is regulated in the Economic chapters of the Constitution.² Under the Constitution the economy must be structured ‘...as a common endeavour based on familial principles’.³ The Constitution holds that production sectors that are vital to the state and affect the livelihood of a considerable part of the population are to be *controlled by the state*.⁴ Oil and Gas, geothermal, some of the mining activities and the water sector fall within this category.⁵

Private entities are barred from directly exploiting water resources due to this scheme. However, it is possible to conduct exploitations through mechanism which does not take away the right of the state

¹ See. Indonesia, Constitution of the Republic of Indonesia Year 1945 and Its Amendments, Articles 28 B (2), 28 C (1), 28 H (1), 28 H (3) and 28 I (3)

² *Id.* Chapter XIV

³ *Id.* at Article 33 (1)

⁴ *Id.* Article 33 (2). Similar provision can be found in Article 7 of the Constitution of People’s Republic of China and Article 7 of the Constitution of Russia 1993.

⁵ This is affirmed by Law No. 1 Year 1967 concerning Foreign Investment (State Gazette Year 1967 Number 1) Article 6 which states: ‘The business sectors that are completely closed to foreign capital investment are sectors which of vital importance to the State, and strongly affect the livelihood of many of the people, including: harbors; production, transmission and distribution of electric power for the public; telecommunication; navigation; aviation; drinking water; public railways; atomic reactors; mass media.’ In order to tackle this provision, private parties often create an company under PMDN (national capital investment) scheme, however in order to perform such scheme, foreign parties must share a great deal of portion of the ownership in the company with other local parties. See. Indonesia, Law No.1 Year 1967 on Foreign Investment

in controlling water resources. In practice, this can be conducted through cooperation contract or concession contracts.⁶

One of the most important factors in examining whether a privatisation scheme has deviate from the Constitution or not is its price determination mechanism. Indonesian Constitutional Court had annulled several Articles on Law number 22 Year 2004, which relinquish oil and gas price determination to the market's mechanism.⁷ As a consequence to this decision, price determination of any future products resulting from private participation of vital natural resources cannot be relinquished to the market's mechanism.⁸

Being regulated by both human rights and economical provision of the constitution, water resources regulation shall be more stringent compared to oil and gas sector. This requirement can be complicated when translated into implementing regulations or contract clauses.

ii. Privatisation under Water Resources Law

The Law recognizes two kinds of right, "water use right" and "water exploitation right", both may not be leased or assigned, partially or entirely.⁹ Water use right applies for daily basic needs for individuals and for smallholder estate crops within the irrigation system, which generally can be executed without permit.¹⁰

"Water Exploitation Right" can be given to individuals or enterprises pursuant to the permit from the Government or regional government.¹¹ This is where privatisation becomes possible.

⁶ Implementing Regulation of the Foreign Investment Law (See Note 5 above), the Negative List of Investment, makes it possible for foreign investment in potable water under joint venture scheme. *See*. Indonesia, Negative List of Investment, Attachment III. Retrieved from the Indonesia's Investment Coordinating Board website on February 28th 2007 <http://www.bkpm.go.id/bkpm/dni.php?mode=baca>

⁷ *See*, Indonesia, *Judicial Review of Law No. 22 Year 2001 Concerning Oil and Gas*. Decision of the Constitutional Court of the Republic of Indonesia No. 002/PUU-I/2003 dated December 15th 2004 on the.

⁸ 'The Court considered that the Government's intervention in the form of price determination shall be a dominant feature in vital production sectors which involves the livelihood of many people'. *Id.* at p. 227

⁹Indonesia, Water Resources Law, Law No. 7 Year 2004, Article 7 (2)

¹⁰ *Id.* Article 8 (1)

¹¹ *Id.* Article 9 (1)

Article 40 (3) of the Water Resources Law obligate government and regional governments to develop drinking water provision system and stated literally that private parties ‘may participate’ in developing such system, when necessary. Under the present law, every stages of water undertaking are open to private participation¹².

Under a governmental regulation, development of drinking water provision system must be conducted by state owned enterprise or regional owned enterprise (SOE), formed exclusively to develop drinking water system¹³. The regulation clarifies that when SOE(s) are unable to increase its quality, it may conduct cooperation with private parties.

iii. Status of the Law

Three months after the Water Resources Law was enacted, a group of civil societies submitted a judicial review of the law to the Constitutional Court. In its decision, the Court (with 7 concurring and 2 dissenting) held the Law to be “Conditionally Constitutional” (“Decision”). It considers the Law to be sufficient in protecting the citizen’s right and is so far compatible with the Constitution insofar as its implementation is consistent with what has been outlined by the Court in its Decision.

“Implementation” under the Court’s Decision can be broadly interpreted as it can mean Implementing Regulations of the Law or the Government’s practice in the form of decrees, circulars or unwritten decision of the bureaucracy

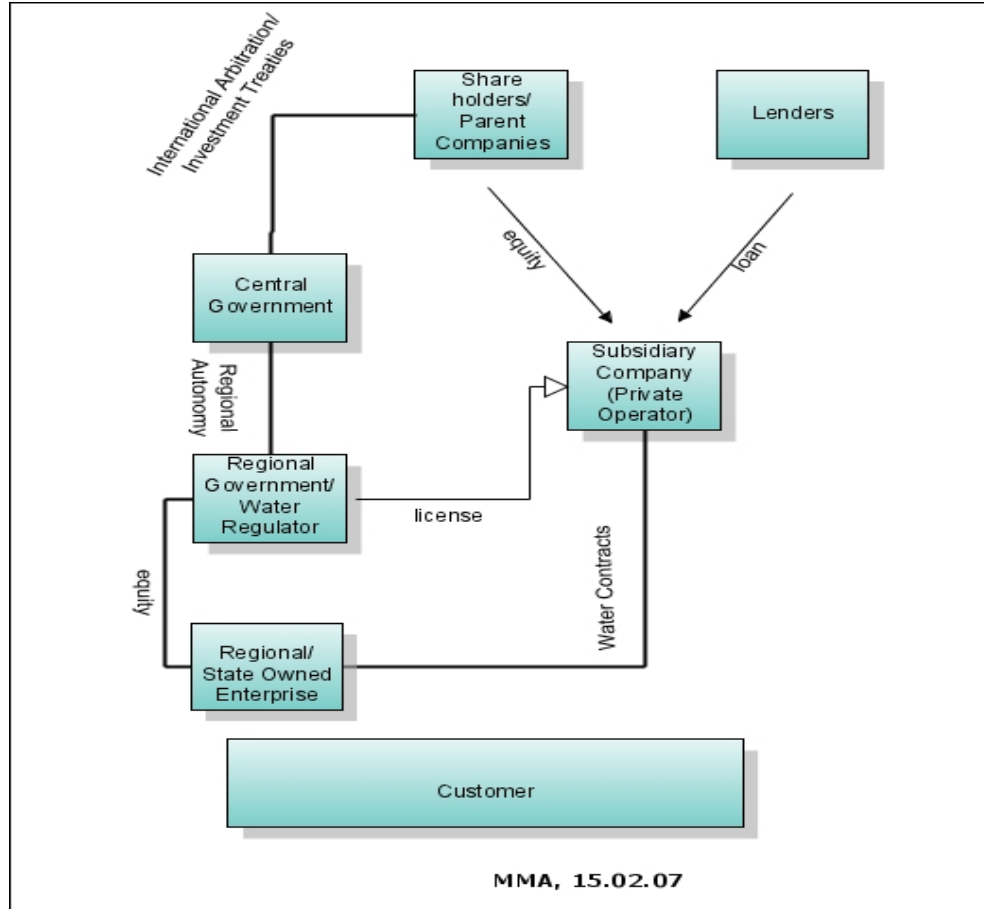
c. Institutions involved in water contracts

Large scale water projects typically involve various institutions, which may be governed by more than one jurisdiction. The figure below illustrates the institutions and the relationship among them d in a privatised water undertaking.

¹² *Id.*, Article 40

¹³ Indonesia, Government Regulation 16 Year 2005 on the Drinking Water Provision System, Article 37 (2)

Fig.1.1.



(Note: This figure is relevant insofar as a subsidiary company is established, thus it may exclude “management contract” privatisation model)

Due to regional autonomy, the key player to privatisations in Indonesia will be the Regional Governments. Central government does have a role in giving licenses for water investments, however, when it deems that regional government is able to exercise its authorities, the law enables regional government to administer licenses.¹⁴ The second reason why regional government is a key player is because they have stakes in regional enterprise, which engages themselves in a drinking water provision agreement with a private operator.

The second player involved here is the local private operator, a subsidiary company incorporated in Indonesia. Oftentimes, the foreign investor form an alliance with national businessmen who would in turn invest a

¹⁴ Water Resources Law. See note 9 above, Article 19 (1)

substantial amount of shares in the subsidiary company and provides political protection.¹⁵

Private operator obtained their assets through capital injection from shareholders and loans. The shareholders could be either an individual person or a foreign company incorporated in a foreign jurisdiction. This is where the problem becomes more complex, as both the private operators and its shareholders can actually be the same economic entity, but are legally distinct.

Central government plays a vital role in supervising the regions in conducting the privatisation for two reasons. First, because they can be dragged into international arbitrations by the private operator's shareholders, as will be elaborated further below and second, central government is a party to judicial review of the water law before the Constitutional Court. The Court has declared that a re-judicial review can be possible if the water law's implementing regulation is not consistent with the Court's recommendation. Thus, central government must supervise regional governments so that their rules will comply with the Court's decision.

Lenders are an important player as well as they finance the investment. Their interest in safeguarding their investment must be put in line with stakeholder's interest. Lenders normally have special privileges to enforce their rights in the event of default. The exercise of this right must be designed in a way that will not jeopardize the continuity of water provision.

The last – and the most important institution – are customers and other stakeholders. The position of customer in the above structure depends on the privatisation model.

d. Models of private participation

There are various known models and degrees of private participation, however, for the purpose of this paper, only a few will be discussed.

Management contracts is a type of private participation conducted by transferring responsibility for managing a utility to a private operator in which the private operator provides management services in return for a fee. As it generally involves no subsidiary company, it will not be discussed in this paper.

¹⁵ Privatisation of Jakarta's Drinking Water Company for example involved the families of former President Soeharto. See Investigasi: Keruhnya Swastanisasi PAM Jaya. *Tempo* No.06/XXVIII/13-19 Apr 1999 P.39-47

Affermage-leases is a system where a private operator is responsible for operating and maintaining the business, retains the fee based on the volume of water sold but does not finance investments in infrastructure. In an affermage system, the private operator's income depends of the water volume sold multiplied by "affermage fee" decreases by operation and maintenance cost. In leases, the private operator retains revenue from customer tariffs, and pays a lease fee to the contracting authority.

Concessions and divestitures give a private operator responsibility not only for the operation and maintenance of assets but also for financing and managing investment. The difference between the private operator in concessions and divestitures is that the private operator in concessions does not own the infrastructure assets, and in divestitures private operator owns the infrastructure assets. Since the infrastructure asset are owned by private party, divestiture scheme may not be consistent with the Constitution.

In joint ownership the private operator is owned jointly by the government and a private party. The extent to which joint ownership is consistent with the Constitution depends on how control is exercised in the decision making process and how prices are determined.

Under prevailing regulations, private participation is regulated in general under Presidential Regulation 16 Year 2005 concerning Cooperation between government and the private sector in providing infrastructure. This Presidential Regulation covers all infrastructure projects from toll road, telecommunication, oil and gas to water.¹⁶ As the character of water is different from other infrastructure projects mentioned earlier, this Presidential Regulation may not adequately satisfies the constitutional requirement.

e. MNCs in water undertakings

i. *Modus Operandi* of an MNC

MNCs operations could be conducted at the expense of the host state citizens, in the form of environmental damages or poor labor conditions. In a fair transaction, the external costs caused by these MNCs – if it exceeds the company's assets-- should have been borne by their shareholders. However, it is difficult to trespass this boundary due to the legal notion of *limited liability* and that their shareholders are located in another jurisdictions.

¹⁶ Indonesia, *Presidential Regulation No. 16 Year 2005 concerning cooperation between government and the private sector in providing infrastructure*, Article 4(1)

Indonesian company law recognizes that shareholders may become personally liable – beyond the money they had invested -- if they use the company's assets for their personal interests or if they are involved in an action taken by the Company that is contrary to prevailing laws and regulations; or if they have illegally used the assets of the Company causing them to become insufficient to cover the Company's debts.¹⁷ However, this feature is useful only when implemented toward local shareholders. A court can confiscate the shareholder's private assets to make them comply with the court's decision. But when faced with foreign entities, this provision does not have much use as their assets are located in other countries where Indonesian court has no enforcement power.

While MNC's parent companies are incorporated in a jurisdiction of developed nations, their subsidiaries are located in developing countries which have ineffective law enforcement, inadequate environmental standards and poor labor conditions. This is because developing nations are still in the process of improving the functioning of the state by strengthening its structures.¹⁸ MNCs are aware of this process and may take advantage by using the regulatory weaknesses for its benefit.

ii. MNC in water context

When put in a water context, the question is whether the very purpose of MNC – which is to serve the economic interest of their shareholders which are in most cases located in another state – can get along with the interest of water customers. For an MNC's shareholder, water is a matter of investment. Meanwhile for a customer, water is a basic need.

The conflicting interest between “shareholder's value” versus “customer's value” is embodied in a more legal practical sphere. Under most company laws, the relationship between a company officer and the corporation is governed under the notion of *fiduciary duty*, namely that they are responsible to manage the assets of the corporation (comprised of those derived from shareholders and lenders) as an entity.¹⁹ To their shareholders alone, officers are acting in a principal-agent relationship, in which

¹⁷ Article 3(2) of the Indonesian Company Law No.1 Year 1995

¹⁸ McInerney, Thomas F., "Putting Regulation Before Responsibility: The Limits of Voluntary Corporate Social Responsibility" (October 10, 2005). GWU Law School Public Law Research Paper No. 123 Available at SSRN: <http://ssrn.com/abstract=658081> or DOI: [10.2139/ssrn.658081](https://doi.org/10.2139/ssrn.658081)

¹⁹ Flannigan, Robert, "Fiduciary Duties of Shareholders and Directors" . Journal of Business Law, p. 277, 2004 Available at SSRN: <http://ssrn.com/abstract=628775>

the directors are acting as a trustee and the shareholders are acting as the beneficiary.²⁰ These concepts are questionable as they may not be comparable with *public service* spirit notion in water provisions. A company officer could be in breach of its fiduciary duty to shareholders if he or she chooses to prioritize humanitarian reasons legally, over profit as when investors entrusted company officers with a business, their purpose is to create profit and not for charity.

In practice, disputes may occur when determining the amount and implementation of non revenue water and in cutting connections of those who cannot pay the water bill.

iii. The asymmetries

Asymmetries between water stakeholders (government, customers, civil societies) and MNC occurs through two ways. First, MNCs have an effective way of compelling governments to comply with investment treaties through arbitration but on the other hand governments and other stakeholders do not have effective ways to compel MNCs to implement social responsibilities to water customers.

Through Bilateral Investment Treaties (BITs), MNC can sue governments through arbitration forum if their local subsidiary is jeopardized.

Central government -- although they may not be directly involved in any legal relationship with a local private water operator -- can be dragged into an international arbitration by foreign water investor if their local government is unable to honor the water contract.

In an ICSID case, Argentine government was dragged into an international arbitration by Azurix.Corp, a Delaware Water Company, for violating a BIT.²¹ The ICSID preliminary tribunal ruled that they have jurisdiction to adjudicate the matter although the actual concession contract was signed between Buenos Aires regional government and Azurix's subsidiary and that the concession contract between Azurix's subsidiary and the local authority waived any settlement forums other than the La Plata

²⁰ There are no explicit concept of fiduciary duty in the Indonesian Company Law. The concept of 'negligence' and 'fault' which may arise liability under the law is not clearly defined. Thus, the interpretation of these concepts might run parallel to the US' notion of fiduciary duties. See. Tabalujan, Benny S. *Indonesian Company Law, Translation and Commentaries*. Sweet & Maxwell Asia, 1997 P. 26

²¹ The American Society of International Law, *International Law In Brief*. Retrieved in February 15th 2007 from <http://www.asil.org/ilib/ilib0622.htm>

Court²². The Court concluded that BIT and the concession contract governed different matters and that Azurix Corp has a direct legal interest on the case.

This case implies that a clause in a contract between a subsidiary company with local government does not guarantee the exclusivity of dispute settlement.

The second asymmetry concerns imposition of international obligation to governments in providing clean and accessible water while at the same time, MNCs practising water provision are not obligated to do so.²³ This means that in cases where water privatisation occurs, states can be held liable under international law if the subsidiary company of MNCs fails to perform its duties. In other words, state might have to bear the burden of fault for MNCs wrongs.

Remedies could be available for water stakeholders, if they submit their case under the Alien Torts Claims Act (ATCA) in United States, as the law confers upon the federal district courts “original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations”²⁴. However it may be difficult to claim water right under ACTA. First, ACTA claims will only be effective for violations of *jus cogens* norms such as genocide, crimes against humanity, unlawful detention, slavery and torture.²⁵ Thus, eventhough international law finally recognizes the right to water as a human right, if it cannot be characterized as a *jus cogen* norm, it will not enjoy ACTA privilege. Second, although the characterization as a *jus cogen* is successful, the plaintiff must prove that MNC must *knowingly participate* in the violation.²⁶

The ACTA does not appear to be an effective forum for water stakeholders. As for the time being, it seems that there are no internationally effective remedies for water stakeholders to hold MNC accountable for its failure in providing water, except for those provided in the agreement between private operator and the authorities.

²² Azurix Corp. v. The Argentine Republic, Decision on Jurisdiction. ICSID CASE No. ARB/01/12 page 6

²³ Article 17 of the Berlin Rules obligates States to provide water to persons. *See*. Fourth Report of the International Law Association, Berlin Conference on Water Resources Law (2004).

²⁴ 28 U.S.C. § 1350

²⁵ Doe I v Unocal Corp. US Court of Appeals for the Ninth Circuit. P. 14208

²⁶ Collingsworth, Terry. *The Alien Tort Claims Act, A Vital Tool for preventing Corporations from Violating Fundamental Human Rights*. Retrieved on February 21st from <http://www.laborrights.org/publications/ATCA.pdf>

II. Implementing Regulations of the Water Law

a. Hierarchy of regulation

Indonesia's legal system recognizes the hierarchy of rules ranging from the Constitution, laws, Government Regulations in lieu of Law (Perpu), Government Regulations (Peraturan Pemerintah), Presidential Regulations (Perpres) and Regional Bylaws (Perda). These are the regulation that have general binding effect.²⁷ There are also sectoral regulations such as ministerial regulation which is binding only to specific sector and regulation of the central bank which binds banking, financial institutions and foreign direct investments.

The Water Resources Law mandated the government to enact more or less 25 Governmental Regulations and when this article is written, only one derivative regulation available, Government Regulation No. 16 Year 2005 on the Drinking Water Provision System.

Private participation is currently regulated by government regulations and ministerial decrees which predates Water Resources Law and its judicial review. The regulation of private participation on those decrees and regulation must therefore be modified in order to adjust to Constitutional Court's Decision.

b. Vital sectors must be "controlled by the state"

As discussed in the previous chapter, all regulations must look closely at Constitutional Court's Decision on Water Law. Thus, all existing regulation must be adjusted to the Decision and all future regulation must take into account the consideration of the Decision.

It is important in this regard to remind that Indonesia's Constitution obligate all vital sectors to be "controlled by the state". The Constitutional Court interpreted in its decisions that *controlled by the state* means the state's power to create policy, to manage, to regulate, to administer and to supervise certain sector.²⁸

In the context of water, this could mean that price-determination and access to the machineries, building and administration of the drinking water provision system must be within the government's reach.

²⁷Indonesia, Law No. 10 Year 2004 on the Formation of Legal Rules (State Gazette Year 2004 No. 53, Supplementary to the State Gazette No. 4389)

²⁸ Al Afghani, Mohamad Mova. *Constitutional Court's Review and the Future of Water Law in Indonesia*. 2/1 Law, Environment and Development Journal (2006), available at <http://www.lead-journal.org/content/06001.pdf>

c. Regulation on pricing

“Cost recovery” is one of the pricing principles listed, in addition to ‘transparency and accountability’.²⁹ The “cost” component encompasses operational/maintenance cost, amortisation cost, loan interest fee, “miscellaneous cost” and other ‘normal’ profit.

Existing regulations categorize customers into four “blocks”, the first one covers public facilities, the second block covers public institutions such as hospitals, the third block covers governmental institutions and low-middle income, the fourth covers the high income.³⁰ Cross subsidy is enforced between blocks.

When water provision is conducted by private parties, the tariff is approved by the head of the regions based on the ‘drinking water provision agreement’. If later in practice, the price is determined solely by the agreement, this may contradict the Constitutional Court’s recommendation as the final decision is beyond the government’s control. However, if the agreement serves only as a recommendation to the tariff, it may be consistent with the Constitution.

d. Share Ownership of Drinking Water Companies

One of the dissenting judges at the Judicial Review of the Water Resources Law said that although transfer of water exploitation license is prohibited, companies can still change their ownership through share transfer.³¹

It is therefore reasonable to regulate share ownership of water companies. Future regulations may contain provisions regulating that substantial share transfers must be conducted upon the approval of water authorities and that a violation to this provision may render the transfer of share unenforceable.

Currently, cooperation between a Regional SOE and investor is regulated in general under a joint decision between the interior minister and the ministry for regional autonomy.³² This body of regulation is weak, as they

²⁹ Indonesia, Governmental Regulation 16 Year 2005 on Drinking Water Provision System, Article 60 (3)

³⁰ Indonesia, Regulation of the Interior Minister No. 2 Year 1998 on the Enactment of Water Drinking Tariff at Regional Water Companies

³¹ Indonesia, Decision of the Indonesian Constitutional Court on the *Judicial Review of the Law No. 7 Year 2004 on Water Resources* No. 058-059-060-063/PUU-II/2004, 13th of July 2005.

³² Indonesia, Joint Decision between Ministry of Regional Autonomy and Ministry of Interior No. 43 Year 2000

do not constitute a binding regulation under the Law on the Formation of Legal Rules (see section II.a. above).

The appropriate body of regulation for this provision might be a Governmental Regulation. If regulated in the Regional bylaws, there will be no uniformity between regions and this makes share transfer more difficult to control.

e. Indemnifications to company's officer

The best interest of the private operator's shareholders is not always the best interest of water stakeholders. There could be cases in practice where both interests collide. In order to anticipate this risk, company officers must be indemnified by the corporation if they acted for the interest of their stakeholders on the expense of the corporation. Further research would be required to study the extent of the indemnification.

f. Due Diligence toward the shareholders of the private operator

It is common that a due diligence is made thoroughly towards the local private operator. However, the problem often does not lie on the legality of the private operators themselves, but due to the flexibilities enjoyed by its foreign shareholders and parent companies. There are at least two issues that need to be investigated by governments, (i) use of special purpose vehicles as a parent company to the private operator and identities of its shareholders and (ii) bilateral investment treaties involved.

As has been discussed in Section I, MNCs enjoyed various flexibilities when it comes to investment. An MNC may use special purpose vehicles (SPVs) in order to hedge its parent companies from risks arising out of legal claims and to obtain protection under the BIT enforced between the SPV and the host state.

The means for an MNC to gain a legal standing for BIT claim is omnidimensional. MNC can have a claim through a BIT enforced between the host state and the state where the parent company of the private operator is incorporated (the SPV's citizenship), and it can also bring claim under the BIT enforced between the shareholders of the SPV and the host state.³³ If the country where the SPV's shareholders are incorporated is not a party to a BIT with the host state, MNC can restructure its companies and transfer majority shares to entities which country is a party to a BIT with the host state. This signifies that the notion of "citizenship"

³³ International Waters was able to use the Netherlands-Bolivia BIT after it restructured its company by transferring the shares ownership from a Cayman Island company to Luxemburg/Netherlands Company. See *Aguas del Tunari, S.A. v. Republic of Bolivia*, ICSID, Decision on Jurisdiction (October 21, 2005).

for an MNC is fluid, it can change citizenships in order to find a best position for legal action³⁴.

Another due diligence must be carried out towards the BITs involved. For example, an umbrella clause at a BIT may determine the outcome whether contractual claims can be extended into investment claim. It is also important to check if the BIT specifically requires a degree of exhaustion of local remedies.

g. Bankruptcy, minimum equity requirement and guarantee

Bankruptcy is one thing that must be avoided. If a private operator goes bankrupt, the provision of drinking water to customer is impeded. This may eventually trigger civil unrest and political instabilities.

Bankruptcy in Indonesia is relatively easy. The Law only requires that (i) the debtor has at least two or more creditors (ii) the debt has matured and became payable and (iii) the application can be made either by himself or at the request of one or more of his creditors.³⁵

In order to avoid this risk, the government needs to regulate a reasonable *debt to equity ratio* for private operator. It means that the government must ensure that majority of the financing comes from equity and not debt. Lenders should also be given the right to step in, in the event of private operator's default which can be in the form of taking over the operation of the business.³⁶

Another option is by obligating a mandatory guarantee that will become enforceable in the event of default. This can be conducted through personal guarantee scheme or contract bonds.

On the other hand, the use of receivables as collateral is not recommendable. Experience with some water projects revealed that the use of receivables as collateral may increase insolvency risks.³⁷

h. Public consent on private participation

³⁴ O'Neill, Timothy. *Water and Freedom: The Privatization of Water and its Implications for Democracy and Human Rights in the Developing World*. Colorado Journal of International environmental Law and Policy, Spring, 2006

³⁵ Indonesia, Law 37 Year 2004 on Bankruptcy and Delay on Debt Payment Obligations

³⁶ Worldbank. *Approaches to Private Participation in Water Services, A Toolkit*. The International Bank for Reconstruction and Development/The World Bank. 2006 p. 162

³⁷ Maynilad Service Water Incorporated (MWSI) use limited recourse financing scheme for a 350 million USD loan scheme. See. Esguerra, Jude. *The Corporate Muddle of Manila's Water Concessions*. Wateraid and Tearfund 2003. P. 19

Public involvement in water management under current regulation is somewhat vague. Regulations only stipulate that the development plan of water provision system must be disseminated to the public³⁸. However, it is not clear on how the public can be involved in the decision. The final say on water development plans remains within the hand of regional government and central government, while public only have the right to give recommendation.

Since the public is the main stakeholder in water provision, their involvement must be increased to a level more significant than the current. Regional house of representative needs to be strengthened and involved in the decision making process.

i. Water tender

Tender in public service participations is mandatory according to prevailing regulations.³⁹ Water provisions however have different characteristics from other tenders. Once the investor wins the bid and the agreement is signed, the government's position is relatively weak. Investors can use financial reasons as a ground to renegotiate the contract provision.

Thus, investors must be put to scrutinies with regards to their bid in water tender in order to avoid low bids conducted by them only to win the contract – and later renegotiate the terms and increase its price.⁴⁰

j. Disconnection from network and non revenue water

Existing regulations render authority to operators to disconnect customers from their water network, if they don't pay their liabilities.⁴¹ The conditions where this may apply must be carefully outlined so as not to deprive customer from their right to water, as provided under the Constitution.

Non revenue water, as the formalisation of the right to water under the Constitution must be regulated through a regional regulation. The extent and amount of non revenue water may vary, depending on the amount of customer. To anticipate this risk, the regional regulation must detail the materialization of non revenue water.

³⁸ See, Article 26 (4) of Government Regulation No 16 Year 2005, note 29 above

³⁹ *Id.* Article 64(5)

⁴⁰ Esguerra, note 37 above. p. 6

⁴¹ Regulation No. 16 Year 2005, note 29 above Article 68 (1) (e)

III. Negotiating the Contract Provisions

The government side will be put under difficulties when negotiating a water contract as for the government, the contract is not a zero-sum-game. Any impairment to the business partner – the investors -- will be harmful for the customer and consequently to the government. Thus, for the government, the aim of a water contract can only mean sustainability and continuity of the water provision.

MNCs on the other hand are more at ease in negotiating the contract's provision, as they have nothing to lose but financial and good will risks.

a. Pricing

i. Currency risks

It is important to negotiate whether the price to consumer would include currency risks. Fluctuation on exchange rates may give impacts to costs and costs will give impact to consumer's final price. It is probably more favourable that the government assumes currency risks as increasing price during difficult times is not politically popular.

ii. Price adjustment

The limits in which private operator may renegotiate the contract provision governing price adjustment must be carefully defined. The government must also comply with prevailing regulations on block tariffs.

b. Unilateral termination and unilateral modification of contract

Contracting SOE should have the right to be able to unilaterally terminate or modify the contract. This is important to ensure compliance with the "controlled by the state" doctrine. Typically, cessation of the contract is attached to licenses given by authorities to the private operator, so the state can actually exercise its control by revoking the license. However, license revocation is possible only if the company violates certain standards. License revocation can also be subjected to costly investment arbitration.

In the event where government feels that it is the time to take over the water project – although the contract term has not ended and there are no

specific violations of water provision standards-- unilateral termination could be the best option for governments.⁴²

Unilateral termination or modification of a contract normally comes with adequate compensation from the authority to the private operator. But since not all modification requires compensation, the contract needs to specify which modification is attached to compensation.

c. Choice of law and forum

Exclusive choice of law and forum, referring the dispute to the municipal law and forum of the host state is common in contracts.⁴³ In a drinking water contract, the best option would be to refer any dispute to a local jurisdiction and local law. This is because referring to a foreign arbitration and foreign law may contradict the constitutional provision of “controlled by the state”, as the dispute will be interpreted by a foreign tribunal using a foreign law, thereby barring the state to exercise its “control” thus automatically render the contract void. Secondly, reference to a local dispute settlement institution would enable stakeholder to take part in the process. If referred to a foreign arbitration, the sessions could be held in secrecy and thus prevent stakeholders from intervening.

d. Jurisdiction under the BIT

Although constitutionally required and contractually enforced, domestic measures such as local choice of law and forum will not prevent jurisdiction under other legal venues. In a water contract between SOE and a local private operator, the scope of the dispute settlement provision cannot be extended beyond the parties who signed the contracts. Thus, parent companies and foreign shareholders of the private operator are not bound to the provision of the contracts. These parties may claim the jurisdiction under the BITs enforced between Indonesia and the investor’s state.

BITs are generally applicable only to investment cases. Under BITs, investors normally enjoys privileges such as (i) fair and equitable treatment, (ii) full protection and security, (iii) national and most favoured nation treatment, (iv) no arbitrary or discriminatory measures impairing the investment, (v) no expropriation without compensation and (vi) observance of specific investment undertaking.⁴⁴ The last point is regarded

⁴² Worldbank. Note 36 above, p. 155

⁴³ Venezuela’s 2001 Hydrocarbon Law Article 34 (b) obligates local settlement for oil and gas agreements. See Vis-Dunbar, Damon. *Venezuela dodges arbitration with foreign oil companies; pursues new contracts which would preclude arbitration of future disputes*. Retrieved on February 27th from http://www.iisd.org/pdf/2006/itn_jan12_2006.pdf

⁴⁴ Reed, Lucy: *Guide to ICSID arbitration*. - The Hague [u.a.] : Kluwer Law Internat., 2004, p. 41-54

as an “umbrella clause” as it is possible that investors tried to find parallels between investment claim and contract claim by using this clause.⁴⁵

There are some possible ways to avoid BIT jurisdiction. First, the investors must be compelled to waive its right to claim a BIT jurisdiction in written. Thus, a separate contract which specifically binds the investors needs to be drafted for this purpose. Second, the investors must be compelled to lock their shares from possible acquisitions by other legal entities. This is important as when investors waive their right to claim the BIT, the waiver will only bind the legal entity, but not the shares. Thus, it is possible that the shares are being acquired by another company who would in turn claim injuries.

Nevertheless, this measure may not be effective for two reasons. First, it has been implied in the *SGS v Phillipine* case that it is not possible for an investor to waive a BIT jurisdiction through a contractual arrangement.⁴⁶ Second, MNCs often has a more favourable position in negotiation with governments, when it involves ailing water companies that needs immediate financing.

d. Emergency situation

The contract may need to incorporate a provision governing the transfer of operation for a limited time to local authorities, when management of the private operator refuses to stay in their post during difficult times.

The provision of Jakarta’s Drinking Water System was threatened during the 1998 riots.⁴⁷ While the contract may clearly stipulates that private operator can be exempted from their responsibility in the event of riots, it might be wiser to have a provision which transfer the responsibility from the private operator to local authorities. This way the vacuum of management can be avoided.

The contract will need to carefully outline the circumstances and mechanisms of the transfer of operation.

⁴⁵ *SGS Societe Generale de Surveillance SA v. Islamic Republic of. Pakistan* (ICSID Case No. ARB/01/13), Decision on Jurisdiction (6 August 2003). See also Shany, Yuval, “*Contract Claims v. Treaty Claims: Mapping Conflicts Between ICSID Decisions on Multi-Sourced Investment Claims*”. American Journal of International Law, Vol. 99, p. 835, 2005 Available at SSRN: <http://ssrn.com/abstract=871924>

⁴⁶ *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, Case No. ARB/02/6. Decision on Objections to Jurisdiction: January 29, 2004. Paragraph 154.

⁴⁷ Harsono, Andreas. *Water and Politics in the Fall of Suharto*. Retrieved on February 21st on from <http://www.publicintegrity.org/water/report.aspx?aid=52>

IV. Conclusions

There are in general, three ways to safeguard water contracts in Indonesia. The first is conducted through national and regional regulations, the second is through the water contract and the last is through transnational regulation itself.

The norms holding corporation accountable to stakeholders in water sector in Indonesia must be transformed into regulations for two reasons. First, reliance to voluntary Corporate Social Responsibility norms in Indonesia may not be effective given the high number of corruption, lack of environmental protection, weak civil societies and weak labor unions. Secondly, Indonesian Constitution regards water provision as a state function and a part of human rights. Therefore, its implementation must be outlined in a binding regulation.

With regards to existing national and regional regulation, many of the prevailing laws are not sufficient in regulating private participation in water provision. These regulations need to be adjusted in order to comply with constitutional requirements and developing international perception of water provisions. Specific regulations for public service participation in water need to be enacted, as a *lex specialis* to current PSP regulations.

A standard model contract of *Water Provision Agreement* must be enacted. Negotiation guidelines and due diligence standards need to be prepared by the central government. The government needs to build capacity of the regional authorities if they choose privatisation for their water provision system. Central government need to aid them with qualified consultants to help them in their negotiation process.

As for transnational protection, the case may be difficult. Existing international law have no effective remedy for water stakeholders. Thus, the developing perspective of water as a human right-- which puts the burden to states in providing water to its people -- need to be balanced with the effort of holding water MNC accountable to both their stakeholder and shareholders.

The three protection mechanisms – national regulations, contract and transnational – must be synergized. National regulation and contract alone will not be adequate in protecting the commons.