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Independent Power Producers Face Risks under New Power Purchase Regulation

The Minister of Energy and Mineral Resources recently issued Regulation No. 10 of 2017 on the Principles Governing Power Purchase Agreements ("**MEMR 10**") as part of its efforts to overcome persistent delays in the closing of Power Purchase Agreements ("**PPA**") between Independent Power Producers ("**IPP**"), the sellers of electricity, and state power utility Perusahaan Listrik Negara ("**PLN**"), as the buyer. From the Government's perspective, MEMR 10 is intended to provide greater certainty and thus help reduce the time needed for negotiating PPAs. The ultimate question, however, is whether MEMR 10 will actually expedite the signing of the PPAs or is it skewed to the benefit of PLN, thus potentially lessening the appetite of IPPs and their lenders to invest in projects promoted by PLN?

MEMR 10 requires a PPA, at a minimum, to incorporate terms governing its duration; the rights and obligations of the parties; risk allocation as between the parties; performance guarantees; commissioning and Commercial Operation Date ("**COD**"); fuel supply; operation management system; penalties related to electricity generation performance; termination; assignment; price adjustment; dispute resolution; and force majeure.

The following aspects of MEMR 10 merit particular attention:

1. **Risks on IPP side:**

a. Fuel Supply:

MEMR 10 provides for greater flexibility as regards the fuel supply for electricity generation, with such fuel to be either supplied by PLN or procured by the IPP. This is consistent with recent IPP schemes that we have seen, where in an effort to reduce costs, PLN will directly engage with fuel suppliers and take upon its own shoulders the responsibility to supply fuel to the IPP.

Based on confirmation by the Ministry of Energy and Mineral Resources' Director General of Electricity, a failure on the part of PLN to supply fuel will provide the IPP with a deemed dispatch advantage. Nevertheless, there are a number of other risks facing the IPP with regard to fuel supply, such as a situation where the fuel supplied by PLN fails to satisfy the specifications required by the power plant.

b. Government Force Majeure

It is interesting to note that MEMR 10 expressly includes changes in the laws and governmental actions as events of force majeure that may be invoked by either side – including PLN. Normally, government force majeure may not be invoked by a Party that is affiliated with the Government itself. This provision could potentially jeopardize the principle of sanctity of contract in the case of a PPA.

MEMR 10 provides that in an event of government force majeure that results in the termination of the project or would otherwise halt power generation operations, then both PLN and the IPP will be discharged from their respective obligations. Although MEMR 10 does not specify the consequences or recourses available in such

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circumstances, beyond discharging the parties from their obligations, the current PPA scheme requires PLN to purchase the project from the IPP based on a predetermined price formula. In addition, Law No. 25 of 2007 on Investment (the "**Investment Law**") protects the IPP if the project is terminated due to expropriation, in which cases the State is required to compensate the IPP based on a market value assessment conducted in accordance with generally accepted international practice by an independent appraiser appointed by the parties.

MEMR 10 further provides that government force majeure may result in a price adjustment, as further discussed in paragraph c) below.

c. Price Review

While the incorporation of a price review provision is not something new having regard to existing PPAs, MEMR 10 restricts the ability of the Parties to request a price review to events that are related to changes in the cost structure or changes in the technical details of the project.

Although a change in the technical details is subject to the Parties' mutual agreement, a change in the cost structure is essentially defined as a change in the legislation/regulations related to the following aspects:

- i. Electricity prices;
- ii. Taxation;
- iii. Environment; and
- iv. Energy costs (no further explanation is provided, but presumably energy costs are related to fuel costs).

This provision is consistent with the provision on government force majeure where the IPP is entitled to a price adjustment if a change in the law requires the IPP to incur additional costs or increase its investment. Conversely, PLN is entitled to a price reduction in the event that a change in the law results in a reduction in costs.

d. Termination

MEMR 10 provides that either Party may terminate a PPA on account of the following reasons:

- i. Required permits are not issued;
- ii. IPP's failure to secure financing;
- iii. Significant unexpected costs.

Although MEMR 10 allows the Parties to further define the mechanics and consequences of a termination, there remain concerns with respect to the lack of clarity in the definition of "significant unexpected costs".

It is also not clear from MEMR 10 as to whether the right to terminate a PPA also applies in a situation where the IPP has diligently adhered to the permit application process in compliance with the law but the Government has unreasonably withheld the required permit.

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2. Penalties

a. Penalties Payable by PLN

MEMR 10 stipulates that in the event of a failure to take up electricity that is generated, PLN will be liable to pay a penalty to the IPP. Except for PLN's obligation to pay "deemed dispatch" in the event of a disruption to PLN's network that is not due to force majeure, MEMR 10 does not clarify the amount of the penalties that are payable by PLN. Notwithstanding this, we understand that under the prevailing PPA arrangements, PLN is subject to a "take-or-pay" obligation in respect of a failure to take up generated electricity.

MEMR 10 seems to also suggest that PLN's obligation to take up electricity is limited to a certain period that is agreed on by the Parties, having regard to the loan repayment period to the IPP's lenders. This provision is somewhat ambiguous as it is open to the interpretation that PLN's liability to pay a penalty for its failure to take up generated electricity comes to an end with the full repayment of the IPP's loans.

b. Penalties Payable by IPP

The IPP is liable to pay the following penalties to PLN in the event that the power plant fails to fulfil the requirements under the PPA:

- i. Liquidated damages due to the IPP's failure to meet the COD schedule.
- ii. Availability factor ("AF") or capacity Factor ("CF"), and outage factor (OF) penalties;
- iii. Penalty for a failure to cope with PLN's mega volt ampere reactive (MVAR) in the interconnection system, except where this is at PLN's request.
- iv. Penalty for a failure to maintain frequency required by the electrical grid system (grid code)
- v. Penalty for a failure to meet the required ramp rate.

3. Grandfathering

MEMR 10 is not applicable in the case of:

- a. an IPP tender participant that has submitted a bid (bid closing), or countersigned a letter of intent or a PPA (including any amendments thereto); and
- b. a geothermal electricity generating project that has submitted a bid, been appointed as a tender winner, or entered into an energy sales contract;

prior to the issuance of MEMR 10.

Significantly, based on confirmation by the Ministry of Energy and Mineral Resources' Director General of Electricity, existing PPAs are will be subject to MEMR 10 in the event that an amendment of their PPA relates to the provisions or issues that are governed by MEMR 10.

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4. AHP Commentary

MEMR 10 for the most part reflects the common business practices currently applied in PPAs entered into by IPPs and PLN. Any contractual terms not expressly covered by MEMR 10 are subject to the mutual agreement of the parties. Notwithstanding this, MEMR 10 seems to be drafted more so as to protect PLN from liability with respect to its commitment to maintain fuel supply availability, while also affording the government the right to enforce policy changes on PPAs. These are the two main risks for IPPs under MEMR 10 as they have the potential to diminish legal certainty and impinge upon the principle of sanctity of contract.

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ASEAN Economic Community Portal

With the launch of the ASEAN Economic Community (“AEC”) in December 2015, businesses looking to tap the opportunities presented by the integrated markets of the AEC can now get help a click away. Rajah & Tann Asia, United Overseas Bank and RSM Chio Lim Stone Forest, have teamed up to launch “Business in ASEAN”, a portal that provides companies with a single platform that helps businesses navigate the complexities of setting up operations in ASEAN.

By tapping into the professional knowledge and resources of the three organisations through this portal, small- and medium-sized enterprises across the 10-member economic grouping can equip themselves with the tools and know-how to navigate ASEAN’s business landscape. Of particular interest to businesses is the “Ask a Question” feature of the portal which enables companies to pose questions to the three organisations which have an extensive network in the region. The portal can be accessed at <http://www.businessinasean.com/>.

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