# SOME POSSIBLE LEGAL ISSUES FOR THE IMPLEMENTATION OF JAPAN-INDONESIA ECONOMIC PARTNERSHIP AGREEMENT (JIEPA): FOREIGN INVESTMENT LAWS' PERSPECTIVES

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## A. BACKGROUND

The signing of JIEPA is deemed as the historic moments and marks a new era in economic cooperation between the two countries. JIEPA is the most comprehensive bilateral agreement which consist of 15 chapters and 154 articles. It covers most areas of economic cooperation, including foreign investment. JIEPA is equipped with Implementation Agreement with annexes on "Strategic Investment Action Plan".

As the 2 (two) instruments of ratifications had been submitted by the two countries, JIEPA was effectively entry into force starting from July 1st, 2008. Although there is a high expectation that JIEPA implementation will boost Japan Investment in Indonesia, but it is also anticipated that there might be some constraints on its implementation due to some possible differences on JIEPA system and Indonesian Legal System.

This paper is aimed at exploring and analyzing foreign investment related laws to JIEPA Implementation, including but not limited to its potentials; possible constraints; harmonization and synchronization between domestic law and international law and practices; investment risk (both commercial and non-commercial); disputes settlement mechanism; etc.

## B. THE EXISTING CONDITIONS OF INVESTMENT LAWS AND POLICIES IN INDONESIA AND FOCUSES OF THE STUDY

### 1. *The Current Facts and Situation*

a. Despite the facts that the Government of the Republic of Indonesia have been working very hard to improve its investment climate through a series of policies and regulatory reform[1], but little progress has been made in term of investment attractiveness and competitiveness comparing to other neighboring

1 Some policies and regulations reflecting the Government's efforts to improve investment climates are, among others: Presidential Instruction No. 6 of 2007 concerning Policies on the Acceleration of the Real Sector Development and Empowerment of Micro, Small and Medium-Scale Business; also Presidential Instruction No. 3 of 2006 Package of Policy for Investment Climate Improvement. The latest regulation is Presidential Regulation No. 27 of 2009 concerning Integrated One-Stop Services in the Investment Field.

countries in the region.

b. The poor legal system, including poor law enforcement, high rates of corruption, lacks of legal certainty and integrity of the law enforcer have contributed to the lacks of competitiveness.

c. Considering the importance of consistent implementation of JIEPA as a basic requirement for mutual benefits of both Japan and Indonesia, some possible gaps and/or constraints are anticipated between provisions of JIEPA and domestic law of Indonesia.

d. Some factual cases which involve foreign investors have also shown the existing weaknesses on dispute resolution mechanism and its enforcement in Indonesia.[2]

e. The rates of Japan investment in Indonesia can only be improved if the Government of Indonesia and its community at large pay more serious attention to those deficiencies and have strong commitment to fix it.

### 2. *Focuses of the Study*

Study items on JIEPA and Foreign Investment Related Laws will be focused on 2 (two) main issues: firstly, review and analysis on problem on the implementation of JIEPA and secondly, potential business risk and potential risk for investors. Based on the above focuses, the objectives of this study are:

a. Providing analysis on possible legal constraints on the implementation of JIEPA in relations with existing national laws on investment and other relevant laws.

b. Providing comparative analysis between existing laws and practice on standards of treatment to investors (both local and foreign) on one hand, and based on JIEPA on the other hand, also in relation to international Standard of Treatment.

c. Providing analysis on investment related dispute settlement mechanism in general and in particular on FDI in Indonesia both through adjudication and non adjudication process, including its law enforcement mechanism.

d. Providing analysis on possible commercial and non commercial risk on FDI in Indonesia.

e. Providing some recommendations for the way forward for better implementation of JIEPA.

## C. AN OVERVIEW OF JIEPA PROVISONS AND IMPLEMENTING AGREEMENT RELATED TO FOREIGN INVESTMENT

### 1. *Main Principles and Provisions of JIEPA*

Being the most comprehensive economic bilateral agreement between Indonesia and Japan, JIEPA consist of 15 Chapters and 154 articles. It covers very broad aspects of economic cooperation, among others: taxation, trade in goods, rules of origins, investment, trade in services, movement of natural persons, energy and mineral resources, intellectual property, government procurement, Improvement of business environment and promotion of business confidence, cooperation, dispute settlement, etc. In addition, there are 12 annexes referring to certain chapters and articles. For the implementation of JIEPA, an implementing agreement has been agreed with similar scope of issues. The implementation agreement consists of 8 Chapters and 44 articles with 5 annexes on strategic investment action plan covering: tax, customs, labor, infrastructure and competitiveness/SME.

### 2. *Certain Provisions of JIEPA Related to Foreign Investment*

Specific provisions on investment can be found at Chapter 5. Some basic principles of investment are laid down, such as: national treatment, most favored nation treatment, general treatment, access to the court of justice, prohibition of performance requirements, expropriation and compensation, protection from strife, transfers, settlement of investment disputes between a party and an investor of the other party, temporary safeguard measures, etc.

### 3. *Main Principles and Provisions of JIEPA's Implementing Agreement concerning Investment*

Provisions on investment in the implementation agreement of JIEPA are mainly at its 8 annexes concerning Strategic Investment Action Plan. The Strategic Investment Action Plan cover some important aspects, such as: tax, customs, labor, infrastructure, competitiveness, etc.

On tax issues it covers certain action plan, including but not limited to: establishing and strengthening self-assessment system; reforming VAT for export promotion; protecting tax payers rights; promoting transparency and disclosure; reducing real business cost; promoting human exchange; continuing dialogue on tax.

In the field of customs some action plan has been agreed in order to: reduce administrative obstacles to speed up customs clearance; improving work ethic; socializing new regulation/law and its interpretation; implementing EDI (electronic data interchange) system and on-line DGCE (Directorate General of Customs and Excise) official website; enhancing effectiveness of bonded warehouse; enhancing transparency and fairness; other issues indirectly related to custom activities; enhancing transparency and fairness; and increasing transparency by socializing new regulation/law and its interpretation.

The labor related issues are concentrated on certain important issues, including but not limited to: reviewing the related supplementary regulation of the labor law to ensure competitiveness of private companies; enforcing the

2 Some cases can be noted, among others: Cemex case; Karaha Bodas Corporation Case; Newmont Minahasa Raya case; Aria-West case; Chung Hwa case; etc.

industrial relations dispute settlement law properly to solve the dispute quickly and fairly; promoting social systems (vocational training, job placement and national certification system) to create fair, flexible and productive labor market; simplifying the procedure to obtain business visa for smooth business activities by expatriates; establishing the practical social security program.

Meanwhile action plan on infrastructure covers: enacting a regulatory and policy reform to encourage private investment; making a concrete national plan; having a close communication with investors and other stakeholders; improving the key infrastructure to promote investment, Some real projects includes: facilitating the implementation of the existing power plant projects; completing Jakarta outer ring road; and road rehabilitation.

The strategic investment action plan on Competitiveness of SME is focused on: Strengthening the investment agency's role of providing service to investors; protecting the intellectual property in the domestic market; introducing internationally adopted industrial standard; and deepening the understanding of EPA by the Public.

### 4. *Some Anticipated Issues that could Become Constraints in the Implementation of JIEPA*

#### a. Ratification Issue

An issue that may arise with regard to the implementation of JIEPA is the fact the two countries apply different ratification instruments to the JIEPA. On the one hand Indonesia ratifies JIEPA with Presidential Regulation No. 36 of 2008 without the necessity to get prior approval from its Parliament, while on the other hand Japan ratifies the agreement through the process of approval from Parliament. The question is whether the different of ratification instruments may affect effectiveness in the implementation of JIEPA.

Based on the analysis of the provisions of Law No. 24 of 2000 on the International Ageement, in particular provisions of Article 9 paragraph 2 stated that the ratification of international agreement can be conducted by the Law or by Presidential Decree. Furthermore, Article 10 stated that the ratification of international agreement is conducted by law when dealing with: political issues, peace, defense and security of the State; change of region or change of the determination of boundaries of the Republic of Indonesia; sovereignty or sovereign state rights; human rights and the environment; formation new law; loan and or foreign grants. Meanwhile, ratification of agreements beyond the scope as referred to in Article 10 can be conducted by Presidential Decree. A copy of the Presidential Decree on the ratification of an international agreement shall be submitted to the House of Representatives to be evaluated

From the provisions of Article 9, 10 and 11 of Law No. 24 of the International Agreement as mentioned above, it can be concluded that there are no differences on legal consequences as well as validity between international agreement ratified by law or by Presidential Decree. In this case, although JIEPA is ratified by Indonesia in the form of the Presidential Decree, but the validity as well as its legal force is the same with those ratified by law. The only the differences lies in the procedures and substantive classification.

#### b. Mechanism of Review through Constitutional Court

Another aspect that may arise is related to existing available legal mechanism in Indonesia that a petition to review a Law is possible through Constitutional Court. If a Law is considered violate the 1945 Constitution (as amended 4 times) than it is open to review or even revoke by submitting a petition to Constitutional Court. The Constitutional Court than, based on majority vote, decides whether certain law is violating provisions of Constitution. It is possible that if found out of any violation, such law shall be revoked or some articles (provisions) shall be revised.

In accordance with the provisions of Article 10 paragraph 1 of Law No. 24 of 2003 concerning Constitutional Court, the Constitutional Court have the authority to adjudicate on the first and final stage with a final and binding decision whether certain provisions of a Law are against the 1945 Constitution; settle disputes concerning conflict of competence of state institution of which competence provided by the Constitution 1945; to settle the dissolution of political parties; to settle the dispute about the results of general election.

From the perspective of investment, the mechanism to review the law could create legal uncertainty. Some incentives that are offered to investor in accordance with certain provisions of investment law can be revoked in case such provisions are found out violate Constitution by Constitutional Court. An example of such situation is shown by the decision of Constitutional Court which revoked certain provisions of Law No. 25 of 2007 concerning Investment, particularly provisions on granting automatic extension of land titles' period to investor. Other examples are the cancellation of Law on Electricity and cancellation provisions of articles of Law No. 22 of 2001 concerning Oil and Gas.

#### c. The Issue of Legal Certainty for Investors

Legal certainty is very crucial in every investment activities as it create business predictability. In investment every steps shall be carefully calculated before realization of investment is executed. Without legal certainty, investment risk will be higher.

In order to create legal certainty, it is important for capital importing country (host-country) to have strong commitment and consistency that its legal system works effectively. The creation of legal certainty related to investment may deal with different situation, such as: contract enforcement, acquired rights of the aliens, continuation of business activities, dispute resolution mechanism, law enforcement, etc.

#### d. Continuation of business activities

A guarantee for continuation of business activities is absolutely required by business community (investors). Any changes of national laws and regulations should not, in any way cause detrimental effects to the legitimate rights of

investors, both foreign and domestic investors.

We have recently witnessed the issuance of Decree of Ministry of Health No. 1010 of 2008 concerning Drug Registration (Pendaftaran Obat). This new ministerial decree have negative impact toward continuation of business activities currently conducted by both domestic and foreign based pharmaceutical companies. Under the new regulation, only pharmaceutical companies that have and operate production facilities in Indonesia may acquire drug registration, meaning that only such company may sell its products in Indonesia. Meanwhile existing pharmaceutical company, which do not have any such facilities could not register and consequently could not sell the products of the company they represent. Such regulation clearly create disastrous situation to pharmaceutical companies that do not have production facilities in Indonesia, even though these companies already exist and invested substantial amount of both money, facilities, human resources, etc. Sooner or later, if there is no proper protection to existing companies that suffer from such regulation; this becomes a bad precedent for investment climate in Indonesia. In the long run it may cause relocation of business, termination of activities, capital out-flow to other importing capital countries that offer better protection and/or treatment to investor.

**e. Termination of Business Activities**

It is generally understood that capital will flow to the country that offer better investment climate or to country where investor could expect better return on investment and its profits. When we talk about capital investment, we can not talk about nationalism anymore. Investor from foreign country may come to a country which is perceived as able to create a better investment climate than others. There are many factors that contribute to better investment climate, such as: tax and non-tax incentives, land titles, manpower's productivity, legal certainty, easy to start-up the business, easy to terminate the business, etc.

In addition to the fact that Indonesia is among the country where it take more time and cost to start the business, Indonesia is also perceived as a country where it is difficult to terminate the business. Investor will consider not investing in a country where it is difficult and costly to start as well as to terminate the business. This issue should be properly addressed by Indonesia as a way to support the implementation of JIEPA. The approach shall be both from the level of policy, laws and regulation, and in particular in its consistent implementation.

## D. SOME CRITICAL ANALYSIS TO THE EXISTING FOREIGN INVESTMENT RELATED LAWS IN INDONESIA

### 1. *Law No. 25 of 2007 on Investment*

**a. The Underlying Policies and Further Follow-up**

Some of the policies that underlie the formulation of Law No. 25 of 2007 are reflected in the Presidential Instruction No. 3 of 2006 concerning Policy Package on Improvement Investment Climate which emphasizing on the need to improve the investment climate to enhance economic growth.

The appendix of this instruction elaborates 5 aspects, 19 policies, 85 programs of action (action plan) which is equipped with outputs, the time frame and the individual responsibility.[3] This Presidential Instruction, of course, reflects the seriousness of the Government (at least the President) in its efforts to improve the investment climate in Indonesia.

Furthermore, in order to support the implementation of Law No. 25 of 2007, the President has issued a few instructions such as a Presidential Instruction No. 5 in 2008 concerning Focus of Economic Program for the year of 2008 - 2009, which essentially seeks to increase national economic growth, preservation of natural resources, increased energy and resilience of the quality of the environment, etc. Dictum in the Presidential Instruction also emphasized that these steps be guided by the program that includes improvements to the investment climate, macro-economic, infrastructure, empowerment of micro, small and medium enterprises, etc.

**b. Main provisions**

The main provisions of Law No. 25 of 2007 concerning Capital Investment are: Provide the same treatment to both foreign capital investment (PMA) and domestic investment (PMDN) by taking into account national interest; The government will refrain from conducting nationalization or expropriation on capital and/or property ownership of investors, except it is conducted in accordance with relevant existing Law; Investor may transfer its assets to any party as they wish in accordance with relevant laws and regulations; Guaranteeing the rights of the investor to transfer and repatriate in foreign currency of its capital, profits, royalty, dividends, etc; All fields of business are basically open for investment, except certain field of business that is stated as close to business or open with certain conditions; Provide title of rights with a longer period of validity; Provide immigration services, licenses, and/or facilities upon acquiring recommendation from BKPM (Investment Coordinating Board); BKPM will be chaired by a head directly responsible to the President.

**c. New things from the New Law No. 25 of 2007 concerning Capital Investment[4]**

Based on observation to the new Capital Investment law, it offers some new provisions, among others: The period given to the rights of the land has been extended; A more flexible regulations regarding the use of foreign employee/expatriates; The more open areas of business for

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3 Further analysis of Presidential Instruction No. 3 of 2006, read: Tulus Tambunan, "Investment Climate in Indonesia: Issues, Challenges and Potential", Kadin Indonesia: JETRO 2006, and also M. Ichsan Modjo, "Implementation Package of Investment Policy", Jawa Pos Newspaper, 13 March 2006.

4 Further analysis of the Law No. 25 of 2007 concerning Investment, read: IBR Supancana, The Implementation of Investment Law: Prospects and Challenges, Center for Regulatory Research, April 2007, page 2.

investment activities; The provision of special incentives for certain investment activities, including for "pioneer status" and special economic region.

**d. Some merit in the Law No. 25 of 2007**

The Law also clearly states some provisions which provide some merit, among others: Clearly states its support to Small, Medium, and Micro Enterpraises (SME); There is an incentive for a particular investment, such as "pioneer status" to absorb labor, etc. certainty regarding the rights of the land.

**e. Identified deficiencies and shortcomings:**

1) Some provisions are not applicable as it is not synchronic with other laws, for example provisions on land rights.
2) There is an impression that the new law on investment is only try to protect and accommodate the interest of the investor (foreign) without proper protection to local investors (companies);
3) In some cases, the new law reflects a setback comparing to previous investment law on certain aspects, such as: transfer of technology; the use of expatriates (foreign employee); obligation on divestment, etc.

As a follow-up of the enactment of Investment Law, it is followed by elaboration into lower regulations, among others: Presidential Regulation No. 76 of 2007 on the Criteria and the Requirements of Business Closed and Open to the Terms of Investing in the Field; Presidential Regulation No. 77 of 2007 on the Register of Business Closed and Open to the Terms as modified by Presidential Regulation No. 111 of 2007; Presidential Regulation No. 90 of 2007 on the Investment Coordinating Board.

In addition to special regulations in the fields of investment, there are other regulations that support the betterment of investment climate, for example: Government Regulation No. 1 of 2007 on Income Tax Facilities for Investment in the Field of Specific Business and/at the Specific Region or Area, which is amended by Government Regulation No. 62 of 2008; Government Regulation No. 45 of 2008 concerning the Guidelines of Granting Incentive and Facilitate Investment Activities in the Region.

***2. Law No. 13 of 2003 on Manpower***

Ideally, the Law of Manpower must be able to create working convenience and industrial peace in the workplace. A conducive and peaceful working environment can only be achieved when there is assurance on 3 aspects namely, first, labor protection through insurance; second, the insurance business tranquility; third, through the implementation of security and democracy in the workplace.[5]

Although Law No. 13 of 2003 concerning Labor Affairs was designed to accommodate the interest of both employer and employee, but from the perspective of investor (employer) this law provide too much protection to the labor interest while put more obligation to employer. Meanwhile from the perspective of labor (employee) this law provides more benefits to employer that would become disadvantages for labor (employee) especially when it relates to the issue outsourcing and subcontracting work.

Meanwhile, some are of the opinion to revise the Law on Manpower No. 13 of 2003 on the basis of several reasons: first, some legal provisions are inconsistent, in particular between one and other article; second, viewed in terms of legal drafting, many of the formulation in article are found incorrect and confusing; third, the law is still based on paradigm of conflict, not based on paradigm of partnership.[6]

***3. Law No. 40 of 2007 on Limited Liability Company***

Some identified deficiencies from Law No. 40 of 2007 concerning Limited Liability Company are, among others: provisions concerning legal obligation for CSR (Corporate Social Responsibility); higher minimum capital which make doing business more costly, especially to start-up the business.

***4. Law No. 37 of 2004 concerning Bankruptcy and Suspensions of Debt Payment Obligations***

Despite its ideal objectives, Law No. 37 of 2004 fails to satisfy the following issues: fail to regulate simple evidence system; petition of bankruptcy declaration is not effective as means for foreign creditor to recover its claim from debtor; suspension of debt payment obligations is yet to be the effective tool for corporate solvency.

***5. Law No. 32 of 2004 on Regional Administration***

Although Law No. 32 of 2004 amended previous Law No. 22 of 1999, but most of the substances remain unchanged. The new law still also contains many confusing issues. Viewed from the standpoint of public economy and state finance, the restriction of state affairs into only 16 substances is not appropriate. The law is apparently enacted on the basis of only public administration science whereas the economic of public goods and state finance has vital involvement in public administration, particularly fiscal federation.

## E. COMPARATIVE ANALYSIS ON JIEPA AND INVESTMENT RELATED LAWS IN INDONESIA AND INTERNATIONAL CUSTOMARY LAW FROM THE PERSPECTIVES OF SEVERAL MOST OUTSTANDING ISSUES

***1. Protection and Guarantee on Foreign Investment***

a. JIEPA

Provisions on protection and guarantee on foreign investment can be found at Chapter 5 of JIEPA, particularly in the following articles:

5 Aloysius Uwiyono, "the Implications of Manpower Law No. 13 of 2003 on Investment Climate", Business Law Journal, Vol. 22, No. 5, 2003, pages 9-16

6 Ibid, page 16.

1) National Treatment[7]
2) Most Favored Nation Treatment[8]
3) General Treatment[9]
4) Prohibition of Performance Requirements[10]
5) Expropriation and Compensation[11]
6) Protection from Strife[12]
7) Transfers[13]

b. Indonesian Domestic Law (Law No. 25 of 2007 concerning Capital Investment)

Law N.o 25 of 2007 concerning Capital Investment offers certain protection and guarantee to investment, such as:

1) Equal Treatment to Investors[14]
2) Protection from Nationalization and Expropriation[15]
3) Transfers of Capital and Profit Remmitance[16]
4) Protect and guarantee the Rights of Investors.[17]

c. International Standard of Foreign Investment against Expropriation and Nationalization:

1) Nationalization and expropriations are traditionally based upon the physical taking of property.[18]
2) One important development has been the extension of the concept of protected property to contractual rights.[19]
3) More recent development has shifted the focus from direct takings to individual takings of foreign property.
4) Some cases are qualified as "creeping expropriation" or disguised expropriation involving, for example, the forced divestment of shares of a company, interference with the rights of management, the appointment of managers, the refusal to grant access to labor or raw materials, or excessive or arbitrary taxation.[20]
5) Regulatory taking (in grey areas) for example, taking of property falling within the police powers of the Host State or arise from State Regulations concerning environment, public health, moral, culture or the economy of the host-country. The problem is how to distinguish "justified" regulatory taking and "unjustified" one.[21]

***2. Protection of Acquired Rights of Investor***

a. JIEPA

Within the framework of JIEPA, protection to the acquired rights of alien shall cover certain possible situation caused by host country's act such as: expropriation, nationalization, and confiscation; prohibition of transfer of capital and/or profit; revocation of certain licenses, property/assets, etc.

b. Indonesian Domestic Law

Basically provisions of Law No. 25 of 2007 concerning Investment provide some protection to the acquired rights of alien as long as not against national interest.

c. International concerns

Some countries (mostly capital exporting countries) are concerns about measures taken by Host-State that might seriously harmful to the foreign investor's interest, such as: tax discrimination; the abuse of IPR; the arbitrary refusal to grant licenses; bars to the transfer abroad of funds (capital, royalty, profits, etc) by the investor, bars to the option of investor to hire foreign managerial or specialized staff from abroad.

## F. STANDARD OF IMPLEMENTATION ON TREATMENT TO FOREIGN INVESTORS

***1. National Standard of Treatment***

a. Developing Countries

The traditional position of many developing countries has been that the question of compensation should be decided by reference to provisions in domestic law and not on the basis of international minimum standard.[22]

The position of Developing Countries are mainly based on two (2) main documents, namely "The UN General Assembly Resolution No. 1803 of 1962 on the Permanent

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7 Article 59 para 1
8 Article 60
9 Article 61
10 Article 63
11 Article 65
12 Article 66
13 Article 67
14 Chapter III, Basic Policy, Article 4 (2) and Chapter V, Treatment of Investments, Article 6. ;
15 Ibid, Article 7.
16 Article 8
17 Article 14
18 Read Peter Malánczuk, Akehurst's Modern Introduction to International Law, page 238.
19 Ibid
20 Read also, Peter Malanczuk, "International Law Provisions for the Protection of Foreign Investment", Public Lectures on Public International Law Faculty of Law, Padjajaran University, Bandung, 2 April 2008, page 94.
21 For more clarification, check the R. Dolzer, "Indirect Expropriations: New Developments," New York University Environmental Law Journal 11, 2002, pages 64-93
22 Read, Dolzer/Stevens, supra, page 108. See also FV Garcia-Amador, Calvo Doctrine, Calvo Clause, EPIL I, 1992, page 521.

Sovereignty over Natural Resources" and "The 1974 Charter of Economic Rights and Duties of States".

b. Ex Soviet Union

Involved in principle of national treatment to justify the refusal to compensate aliens. The term "nationalization" was introduced to emphasize the role of the taking of property in the interest of the community instead of focusing on the effect of the expropriation for the owner of the property.[23]

### 2. *International Minimum Standard of Treatment*

Most of capitals exporting countries are in favor of the need to establish International Minimum Standards for the protection of investors (both foreign and domestic). The minimum standards shall cover among others:

a. International minimum standard for the protection of alien and their property

b. Rules of international responsibility of Host-State for internationally wrongful acts

c. The exercise of diplomatic protection by the home state of the alien's nationality

d. Lawful taking of foreign property: for a public purpose; non-discriminatory; and accompanied by payment of compensation.

According to Hull Formula [24]: "no government is entitled to expropriate private property for whatever purpose without provision for prompt, adequate and effective payment therefore".

e. In addition and support to Hull formula, certain terminologies are used with the similar meaning, such as: "market value", "fair market value", "just compensation", "effectively realizable", "without unreasonably delay", "the value immediately before the compensation", and "full compensation".

f. The NAFTA provisions on expropriation and compensation[25] paraphrase the Hull standard while referring to fair market value. The Energy Charter Treaty contains a direct reference to the Hull standard. The APEC Non-Binding Investment Principles of 1994 also reflect the Hull formula. The World Bank Guidelines on the Treatment of Foreign Investment refer to the term "appropriate compensation", but define this standard in a manner that is equivalent to the Hull formula.

## G. THE ISSUE OF INVESTMENT RISKS IN INDONESIA

### 1. *Some of the Investment Risk Classification*

Each investment activity always poses potential risk, the problem is to what extent the ability to identify and manage the risk so that everything can become more predictable.

In general, the risk in investment activity (for example in the field of infrastructure) can be divided into "typical global risk" and "typical elemental risk". [26] In addition to the above "typical global risk" and "elemental typical risk", there are also commercial risk and non-commercial risks.

"Non-commercial risks" are generally understood to include[27]:

- Currency transfer;
- Expropriation and similar measures;
- Breach of contract;
- War and civil disturbances.

In addition to the 4 categories as mentioned above, the parties can also extend the scope of "non-commercial risks" based on mutual consent.

"Typical global risk" includes, among others, political, the risk in terms of legal risk, commercial risks and environmental risk. The "typical elemental risk" includes construction risk, operating risk, financial risk and revenue risk.

Political risks normally associated with the conditions, policies and/or action of the host country such as: stability, expropriation, nationalization, forced sales of assets, the price/tariff; changes in the agreement; increase tax and royalty, the addition of duties, repatriation dividends, change of government, external stability, changes in fiscal policy, debt ratings of State, infrastructure improvement, etc.[28] Risk aspects related to do the concession can occur in various situations, such as: delays in the provision of concessions, the concession period, the determination of tariff by principal, the questions by public, related legislation, commitment to the concession contract, concession exclusivity and competition from existing facilities.[29]

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23 Peter Malanczuk, op.cit, page 98.

24 Formula Hull refers to a declaration made by the Minister of Foreign Affairs U.S. Codell Hull in 1930 in his correspondent with the Government of Mexico after the Mexican's expropriation to US's oil interests. For more analysis, read Peter Malanczuk, ibid, page 96-98.

25 Article 1110 of NAFTA provisionhs on expropriation and compensation

26 On the various risks, please read: A. Merna NJ & Smith, Guide to the Preparation and Evaluation of Build, Own, Operate, Transfer Project tenders, Asia Law & Practice, Hong Kong, Second Edition, 1996.

27 For more commentary on the "non-commercial risks", check the Convention on Multilateral Investment Guarantee Agency (MIGA) in 1985. Read also: I.B.R. Supancana, Research Report Aspect-Aspect Transnational Dispute on Foreign Investment in Indonesia, the results of cooperation between BPHN with the Center for Regulatory Research, Jakarta, 2007, pages 45-46. Check also: Erman Rajagukguk, "Various Aspects in International Law Investment", presented at the Seminar and Discussion on the Development Agreement of the International Investment, BKPM, December 22, 2008, pages 28-36.

28 For more commentary on the political risk, see: Theodore H Moran (eds.), International Political Risk Management: Exploring New Frontiers, MIGA, the World Bank Group, Washington, 2001.

29 See A. Merna & N J Smith, op.cit, page 49.

Legal risk also usually associated with conditions in the host country, such as: the legal framework applicable, change of the laws during the concessions period, conflict with local community, changes in laws and regulations on export and import, the changes in company law, changes to the standard and specification, applicable law on trade, the problem of responsibility (liability), ownership, and others. Legal aspects of risk also arising from the agreement, for example: type the concession contract, the change of the rights and obligations on the basis of the applicable legal framework, changes in contract provisions, the imposition of certain laws to the concessions and to the settlement of disputes. Aspects of the market may also raise the legal risk, in the case: the changes to the facility or kebutuhan up production, the price escalation of raw materials and consumables, recession, economic slowdown, the quality of products, competition, receiving the public on payment system policy, consumer resistance, etc.[30]

Meanwhile, the commercial risks often associated with availability of raw materials. From the currency aspect, commercial risks associated with changes in currency exchange rates, interest rate fluctuations, and the devaluation. Meanwhile, environmental risks can be associated with several sensitive aspects such as project location, existing environmental constraints, and the impending environmental changes. Environmental risks, when viewed from the aspect of its impact can be divided into: the influence of the press re-group, the influence of the external factors toward the operation, the influence of environmental impact, and the influence of the environmental approval. Risk environment can also be caused by the occurrence of ecological changes during the period of concession.[31]

Aspects of "typical elemental risk", will not be elaborated as it is specifically associated with the development and operation of infrastructure projects. In general the amount of risk that can be described that construction risks are influenced by the physical aspects, construction, design and technology. In terms of operations are strongly influenced by the operational conditions, maintenance and training. Financial risk is usually related to the interest rate, repayment, loans, and equity, while the risk of the revenue very related to the needs, the price/tariff and current development/situation.[32]

### 2. *Protection on "Non-Commercial Risks" in Investment Activities on the Based on the provisions of International Law*

As discussed above, MIGA has a very important role in encouraging and protecting foreign investment associated with the "non-commercial risks". Other activities conducted by MIGA include: research, investment promotion, information, investment opportunities, provide assistance and technical advice. MIGA also encourages member countries to conclude agreements on protection and guarantee of investment. MIGA Convention also provides dispute resolution mechanism, whether through negotiation, conciliation or arbitration. In the case such dispute settlement mechanism fail to resolve the dispute, then the dispute can be submitted to the ICSID (International Center for Settlement of Investment disputes).

Investors from member countries of MIGA shall acquire protection and guarantee on investment for their non-commercial risk.

Investment protection and guaranteey related to currency transfer is usually arise in relation with the policies or the determination of the "host country" to limit the transfer of currency to other country or or to be received by other insured parties, including the failure of local government to act within a reasonable time based on investor to request to transfer. [33]

The risk of "expropriation and similar measures can occur due to an action by the law maker or in case the host-country administrative action or does not undertake an obligation which have caused loss to security holders that own or control the rights or loss of substantial that is important for their investment.[34]

The risk caused by breach of contract is occurred when the government violates the contract that it has signed with the investor and the investor does not have a forum to resolve such violation before the court or arbitration. Such risk may also caused by lack of decision concerning the settlement of disputes due to breach a contract, or when there is a decision, but the decision can not be implemented.[35]

Meanwhile, because the risk of war and civil disturbance includes military actions and civil unrest in the region in which investors make investment.

Investments that is protected or that is also called "eligible investments" include: equity interest, including loans and long-term or medium-term guarantee for equity holders in the company, and include forms of direct investment as determined by the MIGA Board. In practice, the majority decision of the MIGA Board, the eligible investment may be expanded.[36]

### 3. *Protection and Guarantee on the "Non-Commercial Risks" Investment Activities in Indonesia*

As a member State of the MIGA Convention, the provisions of investment guarantee and protection of

30 Ibid

31 Ibid, page 50

32 Ibid, page 51-52

33 Erman Rajagukguk, op.cit, page 29.

34 Achmad Yulianto, "the role of Multilateral Investment Guarantee Agency (MIGA) in Investment Activities", in Business Law Journal, Vol. 22, No. 5 of 2003, page 42.

35 Ibid

36 Ibid, page 30

investment, especially concerning non-commercial risks also apply to Indonesia. By comparing to guarantee and protection of non-commercial risks in the investment activities as applied internationally, Indonesia should develop principles, mechanisms regulation concerning guarantee and protection of investment over a non-commercial.

## H. DISPUTE SETTLEMENT MECHANISM

### 1. *Sources of Disputes*

Foreign direct investment activities require effective, efficient, fair and impartial dispute resolution mechanisms as an ideal condition. Such an ideal condition may promote legal certainty and predictability of foreign direct investment and reduce country risk. An ideal dispute resolution mechanism shall be developed both at international and national level.

Sources of FDI disputes can be caused by: policy of host country; violation of obligations by host-country (capital importing State); violation of obligations by home-country (capital exporting State); violation by foreign investor; violation by counter-part in the host-country; violation by local community; and weaknesses in law enforcement mechanism.[37]

Policies of host-country which may cause investment related disputes are, among others: fiscal, foreign debt, currency, agrarian, ownership, state's asset management, manpower, trade and industry, state administration, small and medium enterprises (SME's), and public service. Violation of host-country relating to its failures to: provide equal treatment, protect acquired rights of aliens, protect contractual rights of investors, provide effective and fair dispute resolution mechanism, protects the interest of investor against act of expropriation and confiscation. Meanwhile failures of home-country to direct investor from home-country to respect the sovereignty and not interfere to the internal affairs of host country, also failure to respect human rights, environment and democracy of the host-country may also cause investment disputes.

In some cases, the failure of foreign investor to: comply with laws and regulations of the host country; comply with international legal instruments; and to empower local community of host-country may also cause possible disputes. Breach of contract, expropriation of assets, and forced take-over of shares conducted by counter-part of host country and local communities may potentially cause disputes. Last but not least, weaknesses in law enforcement contribute to the possible disputes, particularly in certain situation like: weaknesses in contract enforcement, ineffective and unfair dispute settlement mechanism and complicated law enforcement mechanism.

### 1. *Parties to the Disputes*

Parties to the disputes might be a variation of the following:

a. State-State
b. Investor-State
c. Foreign Investor-Counterpart from Host-Country
d. Investor- Local Community.

### 2. *Dispute Resolution Mechanism under International Investment Law*

#### a. State-State Disputes

The disputes between States concerning investment can alternatively settled by, among others: Diplomatic Channel (negotiation, consultation enquiries, good offices, mediation, Conciliation); Permanent Court of Arbitration (Permanent Court of Arbitration's Rules of Arbitration); International Court of Justice; WTO Disputes Settlement Understanding (consultation, investigation by the Working Party; standing party experts; authorization of counter measures; third party involvement; panel reports), etc.

#### b. Investor-State Disputes

Some options for settlement of disputes between State and Nationals of other country can be conducted through: Amicable Settlement; International Center for Settlement of Investment Disputes (ICSID); Multilateral Investment Guarantee Agency (MIGA); and National Court

#### c. Investor-Counterpart Disputres

As it is deemed as business-business disputes, the mechanism for settlement can be through different forum, sucah as: Amicable settlement; International Chamber of Commerce/ICC (arbitration, ADR, expertise, dispute board); UNCITRAL (arbitration rules, model law on international commercial arbitration); National arbitration body; National court.

#### d. Investor - Local Community Disputes

The disputes between Investor and local company can be settled through: Amicable settlement; Arbitration; National court.

### 3. *Legal Framework of Investment Related Dispute Settlement Mechanism under Indonesian Law*

#### a. Law No. 25 of 2007 concerning Capital Investment

Under Law No. 25 of 2007 only one article (Article 32) is dealing with dispute settlement mechanism. The provision on settlement of investment disputes as formulated in Article 32 is very general provision and only covers disputes between Government and investor and there is no further elucidation of such provision. Under Article 32 disputes can be settled through: negotiation to reach an acceptable solution; arbitration; available ADR; or courts in accordance with relevant laws and regulations. Dispute between Government and local investor shall be settled through arbitration if the parties so agreed, in case the parties not agree to settle the dispute via arbitration the disputes shall be settled through court proceedings.

37 For further exploration of the dispute settlement mechanism in the foreign direct investment (FDI) in Indonesia, please see: IBR Supancana: "Dispute Settlement Mechanism on Foreign Direct Investment in Indonesia", paper presented at the international seminar on FDI from the Perspective of International Investment Law, Hotel Sahid Jaya, April 1, 2008.

**b. Law No. 30 of 1999 on Arbitration and Alternative Dispute Resolution**

The law is quite comprehensive in regulating settlement of disputes through arbitration, but lacks of provisions on ADR as it only appears in Article 6, which merely focuses on mediation. Some important provisions on arbitration related to: appointment of arbiters; rules and procedures on arbitration; opinion and decision by arbitration tribunals; annulment of arbitration tribunal's decision; etc. Other important provisions related to recognition and enforcement of arbitral awards, both foreign arbitral awards and local/domestic arbitral award.

**c. Law No. 7 of 1994 concerning ratification of WTO**

Agreement of 1994, including annex on TRIMS and Dispute Settlement Understanding (DSU)

By ratifying the WTO Agreement, Indonesia is also bound by provisions on settlement of disputes as formulated in Disputes Settlement Understanding (DSU) through its Disputes Settlement Body. The provisions shall also apply to Trade Related Investment Measures (TRIM's).

**d. Law No. 5 of 1968 concerning Ratification of Convention on Settlement of Disputes Between States and Nationals of other States**

This Convention was initiated by executive directors of the IBRD and until the year of 2002 has been ratified by 136 States. Under the framework of the Convention, ICSID has been established. ICSID provides facilities and mechanism for settlement of investment disputes between States and nationals of other States via the process of Arbitration or Conciliation. Some rules and regulations are available, such as: administrative and financial regulations, institution rules, conciliation rules and arbitration rules. The decision of ICSID shall be final and binding upon the parties and all contracting parties to the Convention shall recognize and enforce ICSID's decision with good faith.

**e. Law No. 4 of 2004 concerning Judiciary**

Judicial authority constitutes authority which is independent for administration of judiciary for purposes of upholding law and justice.

**f. Law No. 14 of 1985 as amended by Law No. 5 of 2004 concerning Supreme Court**

Supreme Court is highest State Court for all matters decided by adjudicative process except for: matters decided by Constitutional Court; certain disputes decided by Industrial Relation Court; disputes over jurisdiction to adjudicate between District Courts in jurisdictional territory of one High Court.

**g. Law No. 2 of 1986 as amended by Law No. 8 of 2004 concerning General Judicial System**

National civil courts are divided into District Courts; High Courts and Supreme Court. District Court is empowered to examine, decide and settle criminal and civil cases in first instance. High Courts are civil and criminal courts of first appeal.

Court system also include Constitutional Court (Law No. 24 of 2003); Administrative Court (Law No. 5 of 1986 as amended by Law No. 9 of 2004); Commercial Court (Law No. 37 of 2004); Tax Court (Law No. 14 of 2002); Religious Court ( Law No. 7 of 1989 as amended by Law No. 3 of 2006); Children's Court (Law No. 3 of 1997); Military Court (Law No. 31 of 1997); Industrial Relations Court (Law No. 2 of 2004); Court of Fishery Affairs (Law No. 31 of 2004); Criminal Corruption Court (Law No. 30 of 2002); Human Rights Court (Law No. 26 of 2000); Islamic Syariah Court (Law No. 11 of 2006).

**h. Presidential Decree concerning Ratification of Convention Establishing Multilateral Investment Guarantee Agency (MIGA)**

Under the Convention, MIGA acts as mediator. MIGA offer several services, such as: guarantee the project against non-commercial risk; provide good offices; help host-country to promote its investment climate. MIGA'a guarantee against non-commercial risk, such as: prohibition or limitation of transfer (currency measures); expropriation and similar measures; war and civil disturbances; breach of contracts; etc. In conducting its function MIGA calculate not only country risk, but also project risk. MIGA also encourage its member countries to conclude agreement on protection and guarantee of investment. Other activities of MIGA include: conducting research; investment promotion; providing information on investment opportunities; provides technical advice and assistance.

**i. Presidential Decree No. 34 of 1981 concerning Ratification of Convention on the Recognition and Enforcement of Foreign Arbitral Award**

The Convention shall apply to foreign arbitral awards by arbitration body outside of the country where the decision should be recognized and enforced. It covers the decision both by permanent and ad-hoc arbitration tribunals. The scope of the decision shall be in commercial field. A state may repudiate to recognize and enforce foreign arbitral award as long as the following situation are fulfilled: invalid/illegitimate arbitration agreement; without proper notification regarding the appointment of arbiters; the tribunal exceeds its power; corrupt; serious violation to existing laws; and lacks of goods consideration as a legal basis for the award.

**j. Regulation of Supreme Court No. 1 of 1990 concerning Procedures for the Enforcement of Foreign Arbitral Awards**

The regulation of Supreme Court No. 1 of 1990 was issued as the consequence of ratification of Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Some important provisions covering: courts with the competence to enforce foreign arbitral award; criteria of foreign arbitral award; foreign arbitral award that can be recognized and enforced; Supreme Court's competences to issue "execuatur"; required procedures for exequatur's application; confiscation procedures; and cost.

**k. The Regulation of Supreme Court No. 2 of 2003 as amended by The Regulation of Supreme Court No. 1 of 2008 concerning Court-Annex Mediation Procedures at Supreme Court**

One of the considerations to issue this regulation is the idea to integrate mediation to the court proceedings which would be effective instruments to overcome bulk of cases

at Supreme Court and to provide a quicker and cheaper dispute settlement mechanism to the conflicting parties.

This Supreme Court's Regulation contains important mediation procedures at courts, covering: general provisions; pre-mediation stage; mediation stage; venue and cost; etc. One of important provision in this regulation is the obligation that all cases in the district court should first be settled amicably through the assistance of a mediator or mediators. Mediator can be from professional mediators or judges at relevant court as long as they can show their neutral and impartial manner in conducting mediation process.

## I. CONCLUSIONS AND RECOMMENDATIONS

### 1. *Conclusions*

Based on the above analysis and elaborations concerning foreign investment related laws in Indonesia in comparison with provisions of JIEPA and its implementations and also by referring to provisions and principles of existing international law, some conclusions can be drawn:

a. That JIEPA is the most comprehensive bilateral economic cooperation agreement and cover a very broad spectrum of economic cooperation. The formulation of JIEPA is very elaborative and even complemented with strategic investment action plan with clear targets. The principles as contained in the agreement also reflecting existing international standard.

b. From the mapping of existing national laws related to foreign investment, observation should be made on the following issues:
   1) In term of scope of regulations are considered sufficient, as they not only regulate the direct investment, but also other regulations that support the investment, such as: the manpower law, company law, regional autonomy law, bankruptcy law, etc.
   2) From the policy side, the Government seriously intends to improve the investment climate through its series of policies.
   3) Some provisions related to the investment still contain some deficiencies and shortcomings which have been identified and need to be improved.

c. In relation with implementation of JIEPA, some issues which could become constraints should be taken into considerations, among others:
   1) There are some differences of ratification instruments between Indonesia and Japan which may probably raise doubts about the effectiveness of its implementation.
   2) The question of effectiveness and legal certainty in the implementation of laws and regulations in relations with public rights to request judicial review through the Supreme Court.
   3) The problems on the protections and the continuity of business activities in case of regulatory changes.
   4) The issues on business termination which are not easy and cheap in Indonesia.

d. Based on comparative analysis to the provisions of JIEPA; provisions of Indonesian Investment Law; and provisions of international law concerning some important issues such as: protection and guarantee of investment; protection to the acquired rights of alien; and minimum standard of treatment to foreign investor, there are some interesting findings reflecting discrepancies on the following subject:
   1) There are provisions found in JIEPA about the investment guarantee and protections which are broad in scope and details in its formulation, whereas in the Indonesian Investment Law, there is still lack of such provisions and less detail.
   2) Provisions on acquired rights as formulated in JIEPA are quite elaborated, whereas under similar provisions in the Indonesian Investment Law, the issue of acquired rights is not well regulated and not formulated in details.
   3) The minimum standard applied by JIEPA is international standard, while in the Indonesian Investment Law (Law No. 25 of 2007) are mostly influenced by national standard.

e. From analysis on dispute settlement mechanism, particularly settlement of investment disputes in Indonesia, in comparison with international dispute settlement mechanism, some notes can be taken:
   1) The mechanism of settlement on investment dispute which are internationally developed vary diversely for any kinds of disputes, both through adjudication process and non-adjudication process.
   2) The mechanism of dispute settlement which are quite developed in Indonesia is still covering certain methods, mainly litigation, arbitration and mediation process (especially mediation used in the court) while other methods have not been developed yet.
   3) From provisions side, there are some laws which regulate procedures on the settlement disputes according to its field and dispute.
   4) One of the aspects which need to be taken into consideration is about the recognition and enforcement of foreign arbitral awards.

### 2. *Recommendations*

In the efforts to improve Indonesian investment climate and to support effective implementation of JIEPA, the following measures shall be taken:

a. Considering the broad scope and details provisions of JIEPA, and in order to ascertain its implementation, there is a need to conduct further in depth study concerning investment related aspects of JIEPA provisions so that the national (Indonesian) laws and regulation could be adjusted to the goals of JIEPA for attaining the mutual benefit of both Indonesia and Japan.

b. For the purpose of improving related laws and regulations concerning investment, various findings and identified deficiencies and shortcomings shall be followed-up and be fixed.

c. Concerning the issues which potentially may become constraints in the implementation of JIEPA shall be scrutinized and must be seriously considered by its stakeholders for further improvements.

d. Some adjustment towards relevant laws and regulations shall be considered mainly concerning legitimate rights of investors, such as: implementation of minimum standard of treatment based on best international practices; maximum protection to the acquired rights of investor through further elaboration and formulation into relevant laws and regulations; and extending investment guarantee and protection with legal certainty.

e. Improvement on investment dispute settlement mechanism is mandatory as a personification of legal improvement and the creation of legal certainty to any party, including investor.

f. Learning from the deficiencies and shortcomings by way of introspection, mainly from actual investment cases that create bad precedence for Indonesian investment climate, it requires more commitment and consistency to fix it. Such attitude not only contributes to the improvement Indonesian legal system, but more than that could improve Indonesian investment climate and its competitiveness.