International Arbitration and Project Finance in Developing Countries: Blurring the Public/Private Distinction

Dinesh D. Banani

Follow this and additional works at: http://lawdigitalcommons.bc.edu/iclr
Part of the Dispute Resolution and Arbitration Commons, and the International Law Commons

Recommended Citation
Dinesh D. Banani, International Arbitration and Project Finance in Developing Countries: Blurring the Public/Private Distinction, 26 B.C. Int'l & Comp. L. Rev. 355 (2003),
http://lawdigitalcommons.bc.edu/iclr/vol26/iss2/9
INTERNATIONAL ARBITRATION AND PROJECT FINANCE IN DEVELOPING COUNTRIES: BLURRING THE PUBLIC/PRIVATE DISTINCTION

DINESH D. BANANI*

Abstract: Project Finance has become an increasingly attractive technique for financing infrastructure projects in developing countries over the last twenty years. Furthermore, the use of project financing raises difficult legal issues with respect to the ability of developing countries' governments to control the provision of public services that are intimately connected to these infrastructure projects. Sponsors of project finance transactions have been relatively successful in dealing with these legal issues by negotiating for international arbitration as the primary forum for resolving potential disputes with the host government. However, as the Himpurna and Patuha power projects in Indonesia reveal, a disciplinary bias exists in the minds of international arbiters with respect to project finance disputes between foreign investors and state entities. This bias has important implications for the future of economic relations between rich and poor nations and the prospects for economic growth in developing countries.

INTRODUCTION

As developing countries have struggled to modernize and industrialize over the past century, their demand for infrastructure development has grown at a staggering rate.¹ To meet this demand for infrastructure development, developing countries have looked increasingly to international project finance to build roads and construct plumbing and electricity systems.² Project finance is a debt finance technique used for the development of a public infrastructure project where lenders rely primarily on the cash flow produced by the

---

*Dinesh D. Banani is an Executive Editor of the Boston College International & Comparative Law Review.


project to service their loan rather than on other sources of payment such as government guarantees or project sponsors' assets or credit. Project finance has several advantages, such as the opportunity for investors to participate directly in an otherwise inaccessible and lucrative—albeit risky—market and the ability to participate in high-risk investments without diminishing creditworthiness.

Despite the appeal of project finance, the extensive amount of political risk associated with the unstable legal regimes of developing countries has forced many investors seeking to finance and construct projects in developing countries to address appropriately and allocate this political risk. As a result, investors have increasingly sought to negotiate international arbitration provisions into their financing agreements to provide a more efficient and favorable means of dispute resolution for conflicts that arise from project finance transactions. Developing countries, however, have argued that international arbitration is inherently biased against them because the procedures for arbitration are based on notions that international projects involve private lawmaking and, therefore, should not be governed in any way by public concerns that may justify the suspension or cancellation of contractual obligations under a financing agreement.

This note will assess and analyze the proposition that the governments of developing countries sometimes are justified in encroaching on the rights of foreign investors and lenders in project finance transactions for the purpose of maintaining their sovereignty over the important public services that project financing usually provides. Part II of the note provides important background information on the workings of project finance, international arbitration, and the relationship between these two forms of conflict resolution or risk minimization. This Part also provides background information on the public/private distinction and the way in which arbitration proceedings can place the public and private lawmaking aspects of international project finance at odds with each other. The Patuha and Him-

---

3 Id. at 1273.
5 Stelwagon, supra note 1, at 54-55.
Purna energy projects in Indonesia will be used as dual case studies to analyze this proposition. Through specific illustrations from the Purna and Patuha energy projects, Part III delineates important issues that the intersection of project finance, international arbitration, and development raises for the argument that an inherent bias still exists between developed and developing countries in international commercial arbitration proceedings. Part IV takes each of these issues in turn and applies them to the Purna and Patuha case studies to argue that there is still a disciplinary bias in the minds of international arbiters with respect to project finance disputes between foreign investors and state entities in developing countries. The note concludes by arguing that this bias has important implications for the future of relations between rich and poor nations and the prospects for economic growth in developing countries.

I. BACKGROUND

A. A Brief Primer on International Project Finance

Historically, infrastructure projects have been public works funded by public funds, usually either tax revenues or proceeds from government bonds. They generally have been too costly for private sector participation because of the large initial capital outlay, the slow rate of return, and the risk that the project may never be profitable. Many developing country governments regarded the services that infrastructure projects provide—such as sewer systems, telecommunications services, and public electricity—as public goods and, therefore, services that should be provided with the mandate of the welfare state.

However, in the last twenty years, infrastructure development has been funded increasingly by private sources of capital. This private funding increasingly comes from outside the developing nation in the form of foreign direct investment. The increase in receptiveness to foreign direct investment was spurred by the inability of governments

9 Id.
11 McCutcheon, supra note 8, at 411.
12 Id.
to pay for large-scale infrastructure projects because of growing fiscal deficits, increasing financial instability, and consequently stagnating rates of economic growth.13

Project financing is the most important legal and financial means by which this shift to private development in infrastructure growth has taken place.14 It involves a method of private financing where the repayment of the funds borrowed for an infrastructure project is dependent upon the revenue generated by the project itself.15 Project finance has been used to fund projects in a wide range of industries, including oil and gas, electricity, telecommunications, transportation (e.g., toll roads), and natural resources (e.g., copper mines and gold mines).16

The sponsors of the project are usually large investors, both domestic and foreign, who take an equity stake in the project.17 The lenders for a project are primarily large international commercial banks, such as Deutsche Bank and JP Chase Securities, or multilateral lending agencies, such as the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).18

The first step in setting up a project financing usually involves the sponsors forming a project company, which is designed to construct, own, and operate the project facility.19 This project company is a corporation that is owned and managed by the sponsors and is designed to borrow funds for the project from the lenders.20 Since the project company, and not the sponsor itself, is the entity that is borrowing funds for the project, the project does not affect the balance sheet or creditworthiness of the sponsor directly.21 The lenders loan money to the project company with the assets and cash flow of the project acting as the security interest for the project loans.22 The lenders, furthermore, loan this money with the expectation of a constant cash flow from the project and a continuous operation of the project.23

---

13 See Nassar, supra note 10, at 60.
14 McCutcheon, supra note 8, at 412.
15 Nassar, supra note 10, at 62.
17 Nassar, supra note 10, at 62.
18 See id. at 63.
19 See Pedamon, supra note 2, at 1273.
20 Id.
21 See Blumental, supra note 4, at 270.
22 See Nassar, supra note 10, at 62.
23 Id. at 65.
realize these goals, the lenders use contractual agreements with the sponsors of the project to guard against potential threats.24 The sponsors, in turn, seek guarantees from the host government that it will provide the necessary assurances to keep the project running smoothly.25

The Dabhol power project in India, which completed its financing in 1995, is a good example of how a project financing works in practice.26 Three sponsors, Enron Corporation, General Electric Capital Corporation and Bechtel Enterprises, invested funds into the project by creating a project company called Dabhol Power Company.27 This project corporation then independently borrowed funds for the project from multilateral lending agencies, local lenders and a syndicate of investment banks.28 The security these lenders sought for providing these funds were the assets and cash flow of the project entity, the Dabhol Power Company.29

Sponsors obtain several commercial advantages by financing a project in this manner.30 First, if the project fails to fulfill its loan obligations to the lenders, the only recourse the lenders have is to the assets of the project corporation itself.31 They have no recourse to any of the assets on the parent corporation’s balance sheet.32 Second, since the project corporation is acting as the borrower of funds, the parent corporation’s credit rating is unaffected even though the corporation is investing in a long-term project that is borrowing millions of dollars in the frequently unstable environment of developing countries.33

Furthermore, financing a project through project financing can be a vehicle for social and economic development for developing countries because it is a relatively economically efficient way to finance public works projects that affect the lives of millions of people in the country.34 It is also an important channel for developed and developing countries to become more economically integrated be-

24 Id.
25 See id. at 63–64.
27 Id.
28 Id.
29 See Nassar, supra note 10, at 62.
30 Sozzi, supra note 4, at 447.
31 See Pedamon, supra note 2, at 1273.
32 Blumenthal, supra note 4, at 270.
33 See id.
34 See Pedamon, supra note 2, at 1274; see also Nassar, supra note 10, at 65.
cause some of the projects funded through project finance involve the exploration of commodities that are primarily exported to developed countries.\textsuperscript{35}

However, project finance also presents significant risks to sponsors and lenders.\textsuperscript{36} Risk factors in a project financing come in a variety of strains, including currency-related risks, risks of government default on payment guarantees, and risks of civil unrest in the country.\textsuperscript{37} Arguably, the most important risks may be those associated with the political and legal instability of the host nation.\textsuperscript{38}

The Dabhol power project provides an excellent illustration of the political risks involved in project finance.\textsuperscript{39} When the project completed its financing, the local state of Maharashtra was run by the Congress Party, which was very amenable to increasing the participation of foreign investors in infrastructure projects in India.\textsuperscript{40} However, in March of 1995, the right-wing nationalist opposition Bharatiya Janata Party (BJP) gained control of Maharashtra and its opposition to the Dabhol power project was a linchpin of its campaign platform.\textsuperscript{41}

On August 3, 1995, the BJP stated its intention to stop construction of the Dabhol power project and abandon the completed parts of the facility.\textsuperscript{42} The BJP made various claims in support of its action, including that the project was environmentally unsound, that the electricity rates resulting from the project would be unaffordable to the population, and that the project was too costly and was awarded without a competitive bid.\textsuperscript{43} Although Enron did try to commence arbitration proceedings in London and legal action in the United States against the state government, the company was eventually able to terminate these proceedings and renegotiate the terms of the contract.\textsuperscript{44}


\textsuperscript{36} Blumental, supra note 4, at 271.

\textsuperscript{37} See generally Stelwagon, supra note 1, at 55–60.

\textsuperscript{38} See id. at 60.


\textsuperscript{40} See id. at 352.

\textsuperscript{41} Id.

\textsuperscript{42} Id.

\textsuperscript{43} Id. at 352–53.

\textsuperscript{44} See Mazzini, supra note 39, at 353–54.
The Dabhol power project example illustrates that project financiers must take great caution in deciding whether the host nation has a legal and political system that is conducive to private investment in infrastructure projects. Furthermore, this risk is amplified when one considers the public importance of many of these projects, since they render public services—such as water, electricity, telecommunications, or transportation—that are of public concern and politically sensitive. As a result, many host governments can institute policies regarding public services that may adversely affect the rights and obligations of international lenders and sponsors under project finance agreements. To counteract these complex risks, many sponsors and lenders have begun to negotiate successfully for international arbitration as the method for dispute resolution with respect to the project agreements.

B. International Arbitration and Project Finance

1. The Perceived Advantages of International Arbitration in Project Finance Transactions

In drafting forum selection clauses for international project finance agreements, international sponsors have had a clear preference for the domestic courts of their seat or place of business. In practice, this has meant that there has been a trend towards the selection of U.S. or English courts as the forum for dispute resolution because of the sponsors’ and lenders’ relations with the financial centers in New York or London and the applicability of New York or English law to the agreement under consideration.

However, in recent years, project financing participants increasingly have grown aware that even the simplest project financing structure includes a network of various interrelated agreements between the sponsors, lenders, insurance companies, and host governments. The multi-contractual, multi-party aspect of the transactions creates multi-party disputes. These multi-party disputes could arise between

45 See id. at 371.
46 Nassar, supra note 10, at 65.
47 See Stelwagon, supra note 1, at 60 (providing examples of host government policies).
48 See Dugue, supra note 6, at 1074.
49 Id. at 1065.
50 Id. at 1072.
51 Id. at 1076.
52 Id.
multiple parties to a single agreement containing a single choice of forum clause or, more problematically, between different parties to different multi-party agreements containing different choice of forum clauses.\textsuperscript{53}

As a result of its ability to deal better with these problems, international arbitration appears to offer a more effective dispute resolution mechanism than a domestic court in cases of these multi-party disputes, which pervade project finance transactions.\textsuperscript{54} For instance, in many project finance transactions, there will be a master project agreement and various subsidiary agreements.\textsuperscript{55} If a dispute arises under the master agreement between the parties of the transaction, it is likely that a dispute has also arisen with respect to one of the subsidiary agreements.\textsuperscript{56} Furthermore, if an arbitral tribunal has jurisdiction over the master agreement through an arbitration clause, it is likely that they will also have jurisdiction over the subsidiary agreements.\textsuperscript{57} In contrast, without a written arbitration clause in the subsidiary agreement, it is unlikely that a domestic court would be able to obtain jurisdiction over the subsidiary agreement and the parties to it.\textsuperscript{58}

Another aspect of international arbitration that makes it a more attractive dispute resolution process in the eyes of foreign investors is the fact that it is a \textit{private} process.\textsuperscript{59} This is especially important for investors who want the details of their quarrels with the governments of developing countries kept quiet from the public.\textsuperscript{60} This advantage may be acute in the project finance process when one considers the public importance of many of these projects.\textsuperscript{61}

The private nature of the arbitration process also provides foreign investors the opportunity to make the process very flexible and adaptable without much interference from public bodies.\textsuperscript{62} For instance, arbitration offers the parties the opportunity to choose their own decision-maker in a way that is usually not possible in court pro-

\textsuperscript{53} Dugue, \textit{supra} note 6, at 1076.
\textsuperscript{54} \textit{Id.} at 1077.
\textsuperscript{55} \textit{Id.}
\textsuperscript{56} \textit{See id.}
\textsuperscript{57} \textit{Id.}
\textsuperscript{58} Dugue, \textit{supra} note 6, at 1077.
\textsuperscript{59} \textsc{Mark Hunter} \& \textsc{Alan Redfern}, \textsc{Law and Practice of International Commercial Arbitration} 23 (2d ed. 1991).
\textsuperscript{60} \textit{See id.}
\textsuperscript{61} \textit{See Nassar, supra} note 10, at 65.
\textsuperscript{62} \textsc{Hunter} \& \textsc{Redfern}, \textit{supra} note 59, at 23.
ceedings.63 One or more arbitrators could be chosen for their special skill and expertise in project finance transactions and, consequently, have the ability to grasp salient issues of fact or law in the dispute so as to save the parties time and money.64 Furthermore, in an arbitral tribunal, the rules of procedure and evidence can also be tailored to a particular project finance transaction in a way that they could not be in the domestic courts.65

In spite of the potential advantage to investors and sponsors, international arbitration has not been very effective in resolving project finance disputes.66 In fact, the Himpurna and Patuha project finance arbitrations in Indonesia reveal that the advantages of using arbitration to settle disputes in project financing may not be so clear.67 In these project finance arbitrations, the clear contractual obligations to arbitrate were given short shrift by the domestic courts of the host state, and broadly accepted judicial doctrines protecting international arbitration from judicial interference largely were ignored.68

2. The Patuha and Himpurna Power Projects in Indonesia

In these two projects, the state-owned electric company of Indonesia, PT Perusahaan Listruik Negara (PLN), entered into Energy Sales Contracts (ESCs) with two project companies, which were established as subsidiaries of MidAmerican Energy Holdings (formerly CalEnergy), the primary foreign sponsor of these projects.69 MidAmerican's two project companies were Himpurna California Energy Ltd. (Himpurna) and Patuha Power Ltd. (Patuha).70 Under the Himpurna ESC, Himpurna agreed to develop a multi-unit power project at Dieng geothermal field in Java.71 PLN, in turn, committed to pay a tariff for available electricity from the project for a period of thirty years.72 Similarly, Patuha agreed under its ESC to develop a generating facility at the Patuha geothermal field, also in Java, with PLN

---

63 Id.
64 Id.
65 See id.
67 See id.
68 Id.
69 Id. at 1126.
71 Kantor, supra note 66, at 1126.
72 Id.
again agreeing to pay a tariff for available electricity from the project.\footnote{Id.}

The state oil company of Indonesia, Pertamina, also entered into a Joint Operation Contract (JOC) with both of the project companies relating to the operation of the geothermal field that would be the source of the energy for the projects.\footnote{Id.} Both the JOC and the ESC were approved “on behalf of the Government of the Republic of Indonesia” by the Indonesian Minister of Mines and Energy.\footnote{Id.} Furthermore, Indonesia’s Ministry of Finance (MoF) issued side letters (MoF letters) to each project company stating that as long as the project company’s material obligations due under the ESC and JOC have been fulfilled, the Republic of Indonesia will cause Pertamina and PLN, their successors and assigns, to honor and perform their obligations as due in the above-mentioned contracts.\footnote{Id.}

The ESC, JOC and MoF letters all contained a provision under which disputes relating to the relevant document would be settled by arbitration in Jakarta, Indonesia, under the rules of the United Nations Commission on International Trade Law (UNCITRAL).\footnote{Id.} Moreover, under Section 8.4 of the ESCs, the parties renounced statutory rights under the Indonesian Code of Civil Procedure and applicable Indonesian laws and regulations to appeal the decisions of the Arbitral Tribunal (Tribunal).\footnote{Id.} The ESCs also provided for Indonesian law as the governing law, but the parties also agreed that:

The Tribunal need not be bound to strict rules of law where they consider the application thereof to particular matters to be inconsistent with the spirit of this Contract and the underlying intent of the Parties and as to such matters their conclusion shall reflect their judgment of the correct interpretation of all relevant terms hereof and the correct and just enforcement of this agreement in accordance with such terms.\footnote{Id.}

The project companies, aware of the acute legal risks of investing in a power project in a developing country, were diligent in their ef-

\footnote{Kantor, supra note 66, at 1127.}
\footnote{Id. at 1128.}
\footnote{Id. at 1129.}
forts to take advantage of the adaptability and flexibility of arbitration by establishing it as the sole method for resolution of disputes under the transaction. To protect themselves further, they purchased $290 million in supplemental political risk insurance coverage from the Overseas Private Investment Corporation (OPIC) and various syndicates of Lloyd's of London. This insurance provided for payment only when the project companies had exhausted all other legal remedies to enforce their agreements.

Once the project structure was in place, the two project companies obtained financing for the project from various international lenders. Even though the project assets acted as the only collateral for the lenders to provide this financing (as is the case with most project financings), the project was able to obtain a sufficient amount of debt financing primarily because of the perceived strength of the commitments made by the Indonesian Ministry of Finance and Ministry of Mines and Energy in the ESC, JOC and MoF letters. These commitments, however, were soon overtaken by extraordinary events in Indonesia and throughout East Asia.

In 1997, the Indonesian economy collapsed under the impact of the Asian financial crisis and, shortly thereafter, in early 1998, the Suharto regime, which ruled Indonesia for decades, also crumbled under the weight of this economic instability. Faced with huge exchange rate fluctuations as a result of the crisis, PLN considered its obligations to purchase power from projects like Himpurna and Patuha impossible to perform. The fall of the Suharto regime also led to a huge amount of political instability in Indonesia and led to accusations of state contracts being manipulated to benefit Suharto family members and friends. Consequently, the new government unilaterally postponed a number of independent power projects, including Himpurna and Patuha, and placed several others on review status.

---

80 Id. at 1128–29.
81 Kantor, supra note 66, at 1131.
82 Id. at 1132–33.
83 Id. at 1129.
84 See id.
85 Id.
86 Kantor, supra note 66, at 1130.
87 Id.
88 Id.
89 Id.
Himpurna and Patuha initiated arbitration proceedings against PLN, claiming breach of the ESC contracts. PLN argued that the contracts were not breached but only "suspended as a result of non-discriminatory governmental measures taken in response to unprecedented economic adversity." The arbitration was conducted under the UNCITRAL Arbitration rules and, on May 4, 1999, the three-member panel awarded $391 million in damages to Himpurna and $180 million to Patuha.

In making the award, the Tribunal considered, and subsequently rejected, a number of alleged defenses raised by PLN, including the following: (1) that the project companies failed to satisfy the contractual requirements in the ESC to engage in good faith settlement negotiations prior to initiating arbitration; (2) that Indonesian law prevented an arbitral tribunal from ruling on a claim for termination of a contract but instead that only a judge could order such termination; (3) that decrees of the government of Indonesia in 1998 suspending the projects excused PLN from breach; and (4) that the doctrines of changed circumstances, force majeure, and good faith excused non-performance by PLN.

PLN was required to pay the arbitral awards to the project companies within thirty days, but failed to do so. Consequently, Himpurna and Patuha filed a second arbitration against the government of Indonesia on June 6, 1999, to enforce the guarantees that the government provided in the ESC, JOC and MoF letters.

PLN retaliated against these actions by filing a motion to vacate the arbitration award in civil court in Jakarta. The project companies unsuccessfully motioned to dismiss and the civil court refused to enforce the award. Moreover, Pertamina, the state owned oil company, sued the two project companies for not including Pertamina in the first arbitration proceeding. Pertamina claimed that it was a party to the agreements between Himpurna/Patuha and PLN. As a result, it

---

90 Bishop, supra note 70, at 687.
91 Id.
92 Id.
93 Kantor, supra note 66, at 1133–34. PLN also argued that CalEnergy may have used links with former President Suharto to win major contracts in Indonesia. Id.
94 Bishop, supra note 70, at 687.
95 Id.
96 Id.
97 Id.
98 Id.
99 Bishop, supra note 70, at 687.
was successful in obtaining an injunction suspending execution of the awards in civil court.\textsuperscript{100}

With this injunction in hand, the Indonesian government refused to participate in the second arbitration initiated by the project parties scheduled to take place in The Hague, Netherlands.\textsuperscript{101} The Indonesian government also filed suit in The Hague to block the tribunal from going forward with the arbitration.\textsuperscript{102} That request was denied and the hearings took place.\textsuperscript{103} The arbitral panel subsequently issued an award stating that the Indonesian government, as a result of its guarantee in the project agreements, was obliged to pay the awards that were issued in the first arbitration.\textsuperscript{104}

After Indonesia's subsequent failure to pay the awards, MidAmerican, the project's sponsor, filed a claim with OPIC under its political risk insurance policy obtained for the projects.\textsuperscript{105} On November 18th, 1999, after agreeing that MidAmerican had exhausted all its possible legal remedies under the contracts, OPIC and various syndicates of Lloyd's of London paid MidAmerican $290 million in a political risk insurance claim for the transaction.\textsuperscript{106}

The problems faced by MidAmerican in Indonesia have led both scholars and practitioners to question whether project financings involving state-owned entities are really arbitrable as a practical matter.\textsuperscript{107} Furthermore, the widespread corruption and chronic political instability within Indonesia that led domestic courts to disregard the arbitration clauses in the project agreements may also lead to the perception that arbitration is ineffective in these instances because developing country governments are unable to uphold these agreements due to the fragility of their political and economic institutions.\textsuperscript{108}

\begin{footnotes}
\item[100] Id.
\item[101] Id.
\item[102] Id.
\item[103] Id.
\item[104] Bishop, supra note 70, at 687.
\item[105] Id.
\item[106] Id.
\item[107] See Kantor, supra note 66, at 1125–26.
\item[108] See id.
\end{footnotes}
3. The Public/Private Distinction and International Arbitration for Project Financings

An alternative explanation for why arbitration in project finance transactions is so ineffective is the inherent conflict that arises in negotiating private law with government entities for matters that have traditionally been in the realm of public law and legislatures. The root of this inherent conflict lies in the view of many developed nations that the law is divided between public law and private law. Private lawmaking is viewed as the consensual negotiation and performance of contracts and the consensual transfer of property between private parties in society. Private lawmaking, therefore, concerns only the parties who desire to create it. Public lawmaking, in contrast, is viewed as the creation of laws by the legislature and the government’s enforcement of these laws, both of which regulate the conduct of individuals in society.

This public/private distinction has pervaded western liberalism for centuries. It represents a separation between the spheres of the state and civil society. It also represents a dividing line of ideological loyalties. Those who fully believe in the validity of the public/private distinction, therefore, may argue for the inviolability of freedom of contract from public interference, for the privileging of individual property rights and for the subsequent limitations of the state in seizing private property.

In the context of international arbitration, the public/private distinction can play an important role in the disciplinary sensibility of arbiters. As discussed previously, commercial arbitration traditionally is viewed as a private process for resolving private law-making disputes that is consensual and changeable by the parties. As a result, arbiters view the practice of arbitration as a mechanism of dispute resolution that resolves private contractual disputes (not public or political controversies), involves the coming together of equals (nei-

---

109 See Shalakany, supra note 7, at 452–53.
110 See id. at 453–54.
111 See id. at 455.
112 See id.
113 See id. at 453–54.
114 Shalakany, supra note 7, at 454.
115 Id.
116 Id.
117 See id. at 464.
118 See id. at 454.
119 Hunter & Redfern, supra note 59, at 23.
ther of whom are coerced by the state to come to a public forum), and resolves private law questions of property rights (not public law questions of sovereign potentials). 120

In the context of international arbitration proceedings for project financing transactions in developing countries, this disciplinary distinction between public and private lawmaking is especially acute. 121 Sponsors of a project will view the financing as a private lawmaking matter and, therefore, will view the use of arbitration as a private and flexible process which is most amenable to this form of private lawmaking. 122 In contrast, public entities involved in project financing may view the projects as public services over which they have final authority. As a result of this difference in perception, these state entities may create situations in which they can encroach upon the private rights and obligations of the private sponsors in arbitration proceedings with the justification that such encroachment is necessary to maintain the sovereignty and authority of the government over important public services. 123

III. DISCUSSION OF ISSUES

A. Arbitration, Project Finance and Pacta Sunt Servanda

One method through which to understand the decisions of the arbiters in project finance arbitration proceedings is to assess their possible underlying assumptions about the relationship between foreign investors and state entities in private contractual disputes. 124 An underlying presumption about this relationship, commonly held by arbitral panels, is an adherence to the doctrine of pacta sunt servanda. 125

In the realm of public international law, the notion of pacta sunt servanda is seen as a type of international constitutional law at the very base of the international legal system. 126 Drawn from the legal frame-

---

120 Shalakany, supra note 7, at 455.
121 See id. at 464 (discussing how the public/private distinction dictated the decisions of the arbiters in the Texaco Award).
122 See Hunter & Redfern, supra note 59, at 23.
125 See id. at 24.
126 Mazzini, supra note 39, at 349.
work of the United States and major western European powers, *pacta sunt servanda* has been interpreted to mean that every international treaty in force binds the parties to it and requires them to perform in good faith.\textsuperscript{127} Furthermore, *pacta sunt servanda* prohibits altering an international agreement for any reason except by mutual consent.\textsuperscript{128}

An adherence to *pacta sunt servanda* is prevalent in the context of international arbitration primarily because arbiters view arbitration as a process where private parties can resolve their disputes without the interference of state action.\textsuperscript{129} Furthermore, when one of these private parties is actually a public entity, the notion of *pacta sunt servanda* resolves the issue of public interference by holding that public entities involved in private contractual matters must legislate and act in a way that would not adversely affect the rights of their foreign contracting partner.\textsuperscript{130}

With respect to project finance transactions, however, *pacta sunt servanda* may not provide such clear answers for arbiters.\textsuperscript{131} In many of these transactions, the funds for the project come from private sources, and the agreements may be signed by state-owned entities in their capacity as private contracting parties.\textsuperscript{132} At the same time, however, the great public importance of many infrastructure projects may make them amenable to a myriad of government regulations that could place them squarely in the domain of public regulation.\textsuperscript{133} An application of *pacta sunt servanda* may lead an arbiter to conclude that no public regulation can contravene the contractual rights of the foreign sponsor that is in a contractual relationship with a state-owned entity. This conclusion still leaves open the important issue of whether an arbitral decision of this strain contravenes the sovereign rights of states to legislate and adjudicate the conduct of their societies.\textsuperscript{134}

\begin{footnotes}
\footnote{127}{Id. at 346.}
\footnote{128}{Id. at 348.}
\footnote{129}{See Shalakany, supra note 7, at 459–60 (discussing how the Texaco-Libyan Oil arbitrations decisions were indicative of the application of *pacta sunt servanda*).}
\footnote{130}{See id.}
\footnote{132}{See McCutcheon, supra note 8, at 413–14.}
\footnote{133}{See Nassar, supra note 10, at 65.}
\footnote{134}{See Waelde & Ndi, supra note 131, at 244 (discussing the doctrinal debate between the application of *pacta sunt servanda* and the encroachment on national sovereignty over domestic law making in the context of international investment commitments).}
\end{footnotes}
This problematic application of *pacta sunt servanda* is noticeable in the Himpurna and Patuha project finance arbitrations. The Tribunal decided that PLN and the Government of Indonesia had violated their obligations under the ESC, JOC and MoF agreements because they had signed the agreements as private parties. This raises the issue of whether the decision of the panel was so grounded in the public/private distinction that it contravened the new government’s sovereign right to create policies to deal with the financial and political crisis it was experiencing at that time. Furthermore, the fact that the civil court in Indonesia ruled quite differently than the arbitral panel on the same issues raises the related question of whether the domestic courts of Indonesia possessed a different paradigmatic view toward the situation or, as some scholars have argued, were biased categorically towards the foreign investor community in Indonesia at that time.

**B. International Commercial Arbitration, Project Finance and Contracts Among Equals**

Another perspective from which to view the decisions of the arbiters in project finance transactions is that of the legal capacity of each of the parties in the project finance agreements in dispute. From the paradigm of those adhering to the public/private distinction, the parties in project finance disputes should be seen as contractual equals, despite the fact that one of the parties in the agreement was a state entity who was seeking funds from the private sector. Adherents to the public/private distinction believe that the state, when involved in private transactions as a private contracting party, possesses

---

135. *See generally* Kantor, *supra* note 66, at 1134–36 (discussing the difficulties of the project companies in enforcing the arbitral awards in Indonesia).


137. *See* Kantor, *supra* note 66, at 1125–26 (discussing the resentment of foreign investors by local interests in Indonesia).

138. *See* Award on the Merits in Dispute between Texaco Overseas Petroleum Company/California Asiatic Oil Company and the Government of the Libyan Arab Republic, Jan. 19, 1977, 17 I.L.M. 1, 19 (1978) [hereinafter Texaco Award] (discussing the various reasons which could be envisaged in order to justify a defendant Government’s behavior to suspend a private contract).

139. *See* Shalakany, *supra* note 7, at 462 (noting that a basic issue that had to be resolved in the Texaco decision was whether Libya had contracted in its public law capacity as a superior to the oil companies or whether it had contracted in its private law capacity as an equal to these companies).
no powers to take unilateral action that would breach its obligations under that contract. 140

This notion is evident in the Himpurna and Patuha arbitral awards. 141 In the final arbitral award issued for Himpurna and PLN, for instance, the arbitral panel held that the presidential decrees postponing the project due to the financial crisis gripping the country could not have the effect of releasing PLN, the state entity, from its contractual obligations under the force majeure clause of the contract. 142 The panel reasoned that validating such a claim would allow PLN to use its unilateral governmental powers to escape liability from the contract. 143

However, despite the result in the Himpurna and Patuha arbitral awards, in the context of contracts involving corporations and state entities the international legal doctrine of rebus sic stantibus (doctrine of changed circumstances), which would allow a state relief from liability when the economic conditions of the country change or the welfare of the state requires the contract be rescinded, should have greater scope. 144 This argument may be especially convincing in industries dominated by project finance, such as mining and natural resources, where developing countries may have strong incentives to maintain a certain level of inherent sovereignty over industries that control the destinies of their economies. 145

C. International Arbitration, Project Finance and State Sovereignty

A third perspective from which to view the decisions of an arbitral panel with regard to project finance matters is to analyze whether the decisions of the panel violated the political sovereignty of the country under international law. 146 From this perspective, adherents to the public/private distinction maintain that the notion of an inherent sovereignty of states over their territories lies in the realm of

140 See id. (discussing how the analysis of the issue of Libya's legal capacity in the Texaco award was hinged on the categorization of Libyan actions as either public or private).
142 See id.
143 See id. at A-27.
145 See id. at 31.
146 See Shalakany, supra note 7, at 464 (discussing how the Texaco award's decision on the legality of the principle of permanent sovereignty over natural resources was very much a function of the location of the principle on the public/private divide).
public law, while private property disputes resolved by arbitral panels lie in the realm of private law.¹⁴⁷ As a result, in a situation in which a state has executed an international agreement with a foreign private party, the state cannot invoke its sovereignty to disregard commitments and nullify the rights of the party that has performed various obligations under the contract.¹⁴⁸

The Patuha and Himpurna arbitral awards demonstrated the issue of whether an arbitral panel's decision to take jurisdiction over a state contract violates the authority of state courts.¹⁴⁹ In the arbitral proceedings between Patuha and PLN, PLN argued that under the Indonesian Civil Code, the termination of a contract in the event of failure of performance lies within the exclusive province of the national courts unless an explicit contractual waiver exists.¹⁵⁰ The panel dismissed the validity of this argument completely, arguing that the language of the Civil Code encompasses the authority of an arbitral panel to determine issues of termination within a contract.¹⁵¹

In spite of this result, the notion that arbitration proceedings are private in nature and, therefore, cannot concern themselves with the public and sovereign nature of state entities raises the issue of whether the decision of an arbitral panel can limit seriously the ability of states to enact laws and regulations for the benefit of their societies.¹⁵² This distinction between the private nature of arbitration and the public nature of state policies could even lead to a situation in which the contracting state entity would be forced to seek the permission of the other private parties in a transaction before enacting certain laws or regulations in order to avoid a breach under the contract.¹⁵³

In the context of project finance, this risk of having a state entity's sovereignty compromised may be acute because the industries which predominate project finance, such as natural resources, tend to be heavily regulated industries that have particularly strong public

¹⁴⁷ See id.
¹⁴⁸ Id.
¹⁴⁹ See Kantor, supra note 66, at 1133–34.
¹⁵⁰ See Patuha Power Ltd. (Bermuda) v. PT. (Persero) Perusahaan Listruik Negara (Indonesia), 14 Mealey’s Int’l Arb. Rep. at B-14 (Dec. 1999) [hereinafter Patuha-PLN Final Award].
¹⁵¹ Id.
¹⁵² See Shalakany, supra note 7, at 464 (discussing how the Texaco award indicates that "new laws and regulations [issued by the contracting state] must, to affect the contracting parties, be agreed to by them.").
¹⁵³ See id.
interest considerations. These public interest considerations may necessitate the state contracting party to terminate the contract unilaterally when public interests so require. Furthermore, these considerations may even necessitate the restriction of available remedies for the other private parties that dispute this termination.

IV. Analysis

A. The Blurring of the Public/Private Distinction: Pacta Sunt Servanda and the Himpurna and Patuha Arbitration Proceedings

1. Pacta Sunt Servanda and the Doctrine of Changed Circumstances

In determining the merits of contractual disputes involving state entities, pacta sunt servanda has played a prevalent role in the mindset of international arbiters. As a legal principle, it is the subject of unsurpassed international consensus and, according to one arbiter, "no international jurisdiction whatsoever has ever had the least doubt as to the existence, in international law, of the rule pacta sunt servanda." Consequently, many contraventions of the principle of pacta sunt servanda by state contracting parties have been criticized as being nothing more than attempts to meddle politically with the private sphere of contractual relations.

However, this strict application of the doctrine of pacta sunt servanda in international commercial arbitrations deserves scrutiny. First, pacta sunt servanda traditionally has been a doctrine cited as authority in the realm of public international law and, more specifically, in the law of treaties, rather than in the realm of private commercial law. Second, even within the realm of public international law, the Vienna Convention on the Law of Treaties does not

---

154 See Paasivirta, supra note 123, at 123 (discussing how contemporary international law recognizes that control over natural resources entails particularly strong considerations of public interest).
155 See id.
156 See id. at 195.
157 See Shalakany, supra note 7, at 459 (discussing how Dupuy's decision in the Texaco award was highly predicated on the assumption that pacta sunt servanda governed the contractual relationship between the parties).
158 Id.
159 See id. at 460.
160 See generally Sornarajah, supra note 124, at 24-27 (criticizing the strict application of pacta sunt servanda by international arbiters in commercial disputes).
161 See id. at 24.
sanction the strict use of *pacta sunt servanda*. Article 62 of the Convention recognizes, for instance, that a fundamental change in the circumstances existing at the time the treaty was concluded which radically transforms the scope of the obligations under the treaty will provide a party to the treaty grounds for terminating the treaty.

Furthermore, within the realm of investment contracts between state entities and foreign private parties, *pacta sunt servanda* cannot operate in an absolute sense, not only because it is not applied absolutely in international law, but also because most investment contracts operate in a field which falls within the domestic sovereignty of the state. As a result, there exists greater scope for applying the doctrine of changed circumstances in state contracts, particularly where economic conditions change and the welfare of the state requires that the contract be rescinded or changed. Within the context of project finance transactions, this argument may be especially relevant when one considers that under international law states are recognized to have a certain degree of sovereignty over their natural resources and that a public emergency may require them to take unilateral action which is likely to affect the rights of foreign contracting parties to an agreement.

2. Pacta Sunt Servanda and the Himpurna and Patuha Arbitral Awards

The decisions of the arbitrators in the Himpurna and Patuha arbitral awards clearly presented the doctrinal assumptions of *pacta sunt servanda*. In both sets of awards, the Tribunal considered PLN’s argument to apply the doctrine of changed circumstances as a result of the Asian financial crisis, but subsequently ruled that PLN and the Indonesian Government were still liable respectively for their obligations under the project agreements.

In an opening statement before the arbitral panel, the lead counsel for PLN poignantly evoked the economic context for his argument to apply the doctrine of changed circumstances:

162 See id. at 25.
163 Id.
164 Id.
165 SORNARAJAH, supra note 124, at 26.
166 See Paasivirta, supra note 123, at 194–95.
167 See Patuha-PLN Final Award, supra note 150, at B-31.
168 Id. at B-33; Himpurna-PLN Final Award, supra note 141, at A-41.
The Tribunal has to address the claims which are before it against the background of the economic collapse that preceded the presidential decrees in the last quarter of 1997 and made them necessary. This collapse and its consequences are an important element of the changed circumstances affecting these contracts.

I do not wish to burden you with statistics, but some are quite interesting. In 1998 to 1999, the Indonesian economy contracted by 15 per cent, resulting in more than 5 million workers losing their jobs. The rupiah, although it has been more stable in recent months or weeks, has lost more than 80 percent of its value since the crisis first erupted.

Out of a population of 200 million, the number of seriously poor people in Indonesia is projected to reach 130 million in 1999 as a result of the impact of the decline in job opportunities and an inflation rate that exceeded 75 percent last year.169

Given this change of circumstances, PLN argued that the role of the Tribunal was limited to “leaving the parties to renegotiate the contracts in accordance with the principles that apply when there has been such a fundamental change of circumstances.”170 PLN also reiterated that Indonesian law “does not permit” Himpurna to claim damages for breach of the ESC under the doctrine of changed circumstances.171 PLN supported this contention by arguing that the doctrine of changed circumstances is recognized in Indonesian law as a corollary of the duty of good faith, which appears in Article 1338 of the Indonesian Civil Code.172 Furthermore, PLN also invoked Articles 1244 and 1245 of the Civil Code, which contain the basic principles pertaining to force majeure provisions of contracts.173

The Tribunal conceded that, under Indonesian law, situations exist in which the rule of good faith may operate to dissolve or transform contractual rights or obligations.174 However, the Tribunal made it quite clear that it reserved such a remedy for extreme cases and, more importantly, that the fundamental principle of *pacta sunt ser-
vanda forms the bedrock of civil obligations everywhere. The Tribunal then proceeded to point out the number of defects in PLN’s arguments for changed circumstances in light of the doctrine of pacta sunt servanda.

In the first instance, the Tribunal noted that PLN violated its duty of good faith to abide by the contract under pacta sunt servanda by never responding to the project companies’ offers to renegotiate the contract. Furthermore, the Tribunal held that the project companies did not have any duty to accept unilateral suspension of the ESC. Indeed, it had a right to treat PLN’s unresponsiveness as a breach.

Second, the Tribunal concluded that the doctrine of changed circumstances requires that one take into account the weight of calamitous events on both parties in a transaction. In this situation, the Asian financial crisis led to socio-economic pressure on the Indonesian government, but it could have also led to the bankruptcy of Himpurna and Patuha as project companies if the obligations of the contract were not met. In the Himpurna arbitral award, the Tribunal noted that:

By its count, the Claimant invested some US$289 million in the project. To argue that PLN may simply walk away from its contractual obligations without any regard to these investments, and to say that this argument is based on consideration of good faith, is certainly unacceptable. PLN has never explained why the full brunt of the financial crisis should be deflected on to an innocent party which, moreover, is simply seeking to rely on a contract as it is written.

The third defect that the panel found in PLN’s argument is that PLN’s contractual allocation of risk with the project companies prevents PLN from relying on the Civil Code of Indonesia to relieve itself from liability under a doctrine of changed circumstances. Under the force majeure clause in Section 9 of each ESC, the parties ensured that the risk of governmental action affecting the project would re-

---

175 Id.
176 Id.
177 Id.
178 Id.
179 Himpurna-PLN Final Award, supra note 141, at A-39.
180 Id.
181 Id.
182 Id.
main with PLN by only allowing for the project company to claim that an act of the government of Indonesia constitutes an event of force majeure.\textsuperscript{183} As a result, the parties rejected the notion that PLN could rely on a governmental act—even in response to an economic crisis—to undo its contractual obligations.\textsuperscript{184}

As a result of these defects, the Tribunal concluded that PLN could not relieve itself from liability under a doctrine of changed circumstances, and furthermore, that PLN had violated its duty of good faith under \textit{pacta sunt servanda} not to take unilateral action that would breach its obligations under a contract.\textsuperscript{185} In response to the argument that a rigorous reading of the relevant agreements might exacerbate Indonesia's political and economic crisis and greatly impede governmental efforts to alleviate the crisis, the Tribunal responded:

These entreaties fall on the entirely sympathetic ears of the Arbitral Tribunal, and so they must be perceived by people of good will everywhere. But such considerations cannot deter the Arbitral Tribunal from carrying out its task in accordance with the mandate it has been given by the Parties. The arbitrators cannot usurp the role of governmental officials or business leaders. They have no political authority, and no right to presume to impose their personal view of what might be an appropriate negotiated solution. Whatever the purity of their intent, arbitrators who act in such a fashion would be derelict in their duties, and would create more mischief than good. The focus of the Arbitral Tribunal's inquiry has been to ascertain the rights and obligations of the parties to the particular contractual arrangements from which its authority is derived.\textsuperscript{186}

B. \textit{The Himpurna and Patuha Arbitral Awards and Loyalty to the Public/Private Distinction}

The attitude and tenor of the awards in Himpurna and Patuha reveal a typically strong loyalty to the public/private distinction on the part of the Tribunal. The Tribunal separated political and social concerns from its rigorous analysis of the contractual relationship be-

\textsuperscript{183} Id.
\textsuperscript{184} Himpurna-PLN Final Award, \textit{supra} note 141, at A-39.
\textsuperscript{185} Id. at A-41.
\textsuperscript{186} Id. at A-40.
tween the parties. According to its proponents, the advantages of an adherence to the distinction are its emphasis on the legitimate expectations of the parties, as well as principles of good faith and estoppel. Furthermore, the Tribunal in the Himpurna and Patuha awards pointed out that to act in any other way would "contribute to international uncertainty, which in itself would inhibit international trade and investment."

This dogged adherence to the public/private distinction in arbitral awards like Himpurna and Patuha, however, is subject to criticism. First, the Tribunal in these two decisions invoked the doctrine of *pacta sunt servanda* in the context of an investment contract involving a state entity, even though this doctrine traditionally is invoked in the context of international treaties. The Tribunal never indicated in the awards how it was able to make such a leap of logic, especially considering that the applicable law under the ESC was Indonesian law, which would have perhaps led to the conclusion that the doctrine of changed circumstances and force majeure should relieve PLN from the ESC. Even though the Tribunal had the right to derogate from Indonesian law under the ESC to enforce the spirit of the contract, this right does not lead necessarily to the conclusion that PLN breached the ESC. Most international sources of law support the view that, instead of the loose rhetoric of *pacta sunt servanda*, stricter considerations such as constitutional principles of legal systems tend to cast doubt on the ability of states to fetter their future legislative freedom with a private contract.

Moreover, an adherence to *pacta sunt servanda* in this case may be regarded as a derogation from the principle of state sovereignty in

---

187 See generally id. at A-39 to A-40 (discussing how the political and financial situation in Indonesia cannot relieve PLN of its liability under the ESC under the doctrine of *pacta sunt servanda*).

188 See Paasivirta, supra note 123, at 168–69 (discussing the arguments of proponents for stabilization clauses in international contracts with state entities).

189 Himpurna-PLN Final Award, supra note 141, at A-41.

190 See Paasivirta, supra note 123, at 169 (discussing the flaws in the argument that violations of stabilization clauses in state contracts constitute an internationally unlawful act).

191 See Sornarajah, supra note 124, at 25 (discussing the lack of a basis for arguing that *pacta sunt servanda* should be rigorously applied to state contracts with foreign private parties).

192 Kantor, supra note 66, at 1129; Himpurna-PLN Final Award, supra note 141, at A-39.

193 See Paasivirta, supra note 123, at 169 (discussing how a strict adherence to stabilization clauses may lead to violations of state sovereignty).
international law.\textsuperscript{194} Although the power projects here do not represent natural resources over which the host state can claim permanent sovereignty,\textsuperscript{195} the public interest of the Indonesian state in regulating its utilities, especially in light of the Asian financial crisis, may have justified a certain level of independence for the state in temporarily suspending or terminating the ESC.\textsuperscript{196}

C. Contracting as Equals and the Himpurna and Patuha Arbitral Awards

1. Contracting as Equals and the Administrative Contract

The notion that state entities and foreign private corporations act essentially as equals in their capacity as parties to a private contract is also part of the paradigm of arbiters in international commercial arbitration proceedings.\textsuperscript{197} Contractual equality is hinged on the public/private distinction that the state as a private actor is different from the state as a public actor because, in some state contracts, the state will expressly waive its right to amend laws or regulations that would affect the rights and obligations of the parties under the agreement.\textsuperscript{198} The logical implication of contractual equality is that an attempt by the state to take unilateral action to amend contractual obligations will be found to be unlawful per se under the international law of contracts.\textsuperscript{199}

\textsuperscript{194} See \textit{id.} at 170.

\textsuperscript{195} See \textit{id.} at 183–84 (discussing the concept of permanent sovereignty over natural resources and how it has been incorporated as a principle of international law).

\textsuperscript{196} See \textit{id.} at 194–95 (discussing the prevalence of administrative contracts in many countries). The ESC and other agreements in the Himpurna and Patuha transactions could be construed as "administrative" or "public" contracts, which reflect a necessary accommodation of public or state interests and the interests of individuals. \textit{id.}

\textsuperscript{197} See \textsc{Steven M. Schwebel}, \textit{International Arbitration: Three Salient Problems} 111 (1987). This view of equality can be extrapolated from the view of some scholars that, in a contract between a state and an alien, the use of the sovereign authority of the state, contrary to the expectations of the parties, to abrogate or violate a contract with an alien, is a violation of international law. \textit{id.}

\textsuperscript{198} See \textsc{Paasivirta}, \textit{supra} note 123, at 168–69 (discussing how the incorporation of stabilization clauses restricts the use of state prerogatives in a contract with a foreign private party through the law of treaties). The public/private distinction is couched in this case within the context of stabilization clauses, which are express waivers by a state to use its legislative or sovereign authority in connection with a contract with a foreign private party. \textit{id.}

\textsuperscript{199} See \textit{id.} at 168.
The opposing view is that contracts with state entities should be analyzed under an administrative or public contracts doctrine.\textsuperscript{200} This doctrine, which is generally acknowledged in Continental and Anglo-American legal systems, effectively skirts the rigid boundaries of private law in the face of public regulatory intervention.\textsuperscript{201} The administrative contract doctrine assumes an essentially unequal relationship between the parties, in which the state may exercise its coercive power to take unilateral action in amending its legal obligations.\textsuperscript{202} The state in this case presumably is guided in such actions by the dictates of public interest.\textsuperscript{203} In the context of project finance transactions, this doctrine of the administrative contract may be highly relevant considering the public importance of many projects to the countries in which they are built.\textsuperscript{204}

2. The Administrative Contract Doctrine and the Himpurna and Patuha Arbitral Awards

The Tribunal did not explicitly address the idea that PLN could be excused from liability under the doctrine of administrative contract; however, it implicitly dismissed the possibility of this defense by holding that the MoF letter essentially bound Indonesia to Himpurna and Patuha under the appropriate principles of contract law.\textsuperscript{205} In both the interim awards against the Republic of Indonesia and the final awards against PLN, the Tribunal noted that the state’s (or state entity’s) undertaking of the obligations of the ESC and MoF letters prevented it from using governmental action as an excuse for non-performance under the force majeure clauses of the contract.\textsuperscript{206} Despite the large public interest in revising the terms of the contract because of the Asian financial crisis, the Tribunal noted that the focus of

\begin{itemize}
  \item \textsuperscript{200} See Shalakany, \textit{supra} note 7, at 461–62 (criticizing the decision of the Texaco arbitral tribunal to dismiss the argument that the concession agreements constituted an administrative contract).
  \item \textsuperscript{201} \textit{Id.} at 461.
  \item \textsuperscript{202} \textit{Id.}
  \item \textsuperscript{203} \textit{Id.}
  \item \textsuperscript{204} See Nassar, \textit{supra} note 10, at 65.
  \item \textsuperscript{206} See \textit{id.} (discussing how the Indonesian Civil Code does not provide for valid impediments for a non-performing party unless those impediments are insurmountable, irresistible, and external to the will of the defendant); Himpurna-PLN Final Award, \textit{supra} note 141, at A-40 (discussing how PLN cannot rely on the Indonesian Civil Code to excuse its non-performance under the ESC because it had already expressly fashioned a contractual allocation of risk with Himpurna in case of governmental action).
\end{itemize}
its inquiry must be to ascertain the rights and obligations of the parties to a particular contract. Social and economic circumstances, if within the contemplation of the signatories, cannot be considered a valid excuse for non-performance.207 Because PLN expressly waived its right to suspend the contract as a result of any Indonesian governmental actions, any unilateral action by PLN with respect to the ESC, even if such action represents a directive from the government, constitutes a breach of private contractual obligations.208

This perspective has some troubling aspects, the foremost of which is the possibility that the government of Indonesia’s undertaking in the MoF may have had the effect of limiting the sovereignty of the state by regulating the utilities industry in light of the Asian financial crisis.209 Under principles of international law, in fact, such a perspective appears difficult to maintain considering the established precedent that a contract between a sovereign state and a foreign private entity is usually governed by a municipal legal system, and not the law of treaties.210

C. State Sovereignty and the Himpurna and Patuha Arbitral Awards

1. State Sovereignty and International Arbitration in Project Finance Transactions

Traditionally, sovereignty is known as a principle of international law that provides for certain rights and powers.211 Contracts, in turn, may be conceived as a type of property.212 These two concepts imply that as far as contracts with state entities are concerned, the applicable law between a foreign party and a state or state entity is the law of the host state.213 In the context of the Himpurna and Patuha project finance disputes, the application of the host state’s law would imply that provisions of the Indonesian Civil Code allowing for suspension

207 See Himpurna-PLN Final Award, supra note 141, at A-40.
208 See id. at A-39.
209 See Sornarajah, supra note 124, at 13–14. (noting the speciousness of the claim that an agreement between a foreign private entity and state is binding because the state, pursuant to its sovereignty, had limited its sovereignty by agreeing to be so bound).
210 See id. at 14 (arguing that municipal law of the state, and not an international law of contract, should govern the contractual relationship between a foreign private entity and a state entity).
211 Paasivirta, supra note 123, at 175.
212 Id.
213 See Sornarajah, supra note 124, at 14.
of a contract in case of a change in fundamental circumstances may have been applicable to the relationship between the parties.214

In international arbitration proceedings, however, these assumptions about the sovereignty of the host state in determining the applicable law of its state contracts have been undermined.215 The public/private distinction prevalent in the mind of the arbiter separates the permanent sovereignty of the state from its ability to enter into private contractual agreements with foreign entities.216 As a result, once a state enters into a contract to undertake certain commitments with a foreign private party, it willingly concedes some of its sovereign ability to legislate and regulate the foreign party on certain matters.217

This theory of bifurcating the states' power into public and private spheres is problematic since international law does not fully recognize the legal personality of foreign corporations.218 Furthermore, within the context of project finance transactions, this desire to bifurcate the sovereignty of the host state in the public and private realms is difficult considering the public importance of many infrastructure projects, especially natural resource projects, which have been recognized as being under the permanent sovereignty of states in accordance with international law.219

2. The Himpurna and Patuha Arbitral Awards and State Sovereignty

The arbitral awards that resulted from the Himpurna and Patuha project financings definitely indicate a preference for sovereignty concessions. That is, the Republic of Indonesia had conceded some of its domestic legal authority over the project companies through its undertakings in the ESC and MoF Agreements.220 The awards also make it clear that PLN's argument that the ESC violates the Indonesian constitution is completely specious since PLN entered into numerous contracts with Pertamina and various foreign investors pursu-

---

214 See Himpurna-PLN Final Award, supra note 141, at A-39 (discussing PLN's claim that doctrine of changed circumstances under Indonesian law relieved PLN from liability under the ESC).
215 See SORNARAJAH, supra note 124, at 12 (noting how foreign investors who were increasingly frustrated with domestic courts attempted to fashion a new set of norms emphasizing the primacy and immutability of the investment contract).
216 See id. at 13.
217 See id.
218 See id. at 14.
219 See Nassar, supra note 10, at 65; PAASIVIRTA, supra note 123, at 184.
220 See Himpurna-PLN Final Award, supra note 141, at A-39.
tant to the presidential decrees, which now they themselves are claiming to be unconstitutional.\textsuperscript{221}

Nevertheless, one can argue that the Tribunal's decision to separate the political and financial crisis that gripped Indonesia in 1997 from its obligations to foreign investors under state contracts potentially hinders the government in making economic reforms by regulating the utilities industries.\textsuperscript{222} Furthermore, it is questionable whether the government and PLN even had the legal ability to cede its sovereignty over Himpurna and Patuha through the ESC and MoF since both parties lack the legal personality to participate in the international legal system.\textsuperscript{223}

\textbf{Conclusion}

The Himpurna and Patuha cases not only reveal the difficulties of using international arbitration as a form of dispute resolution for project finance transactions in developing countries, but also they reveal the asymmetric perceptions that still exist between developed and developing countries on the best way to achieve international economic integration. Developing countries in recent years have increasingly grown receptive to the flow of foreign direct investment to create important infrastructure, but at the same time, they are wary of the effects that this type of foreign investment will have on their ability to manage politically in response to international economic fluctuations. Foreign investors have also grown eager to enter developing markets to build large infrastructure projects, yet they are wary of the ability to manage the political risk that comes with these investments.

If foreign investors and developing countries continue to grow increasingly dissatisfied with international arbitration as a process to minimize these risks, it is questionable whether an alternative form of dispute resolution, such as mediation, could act as an agreeable substitute for all parties in a project finance transaction. As a result, the prospects for continued infrastructure growth in the developing world may hinge on the international arbitral community making a paradigmatic shift away from the public/private distinction and towards a more balanced view that recognizes the limited sovereignty of states over infrastructure projects of public importance.

\textsuperscript{221} See id. at A-22.
\textsuperscript{222} See id. at A-40.
\textsuperscript{223} See SORNARAJAH, supra note 124, at 14.