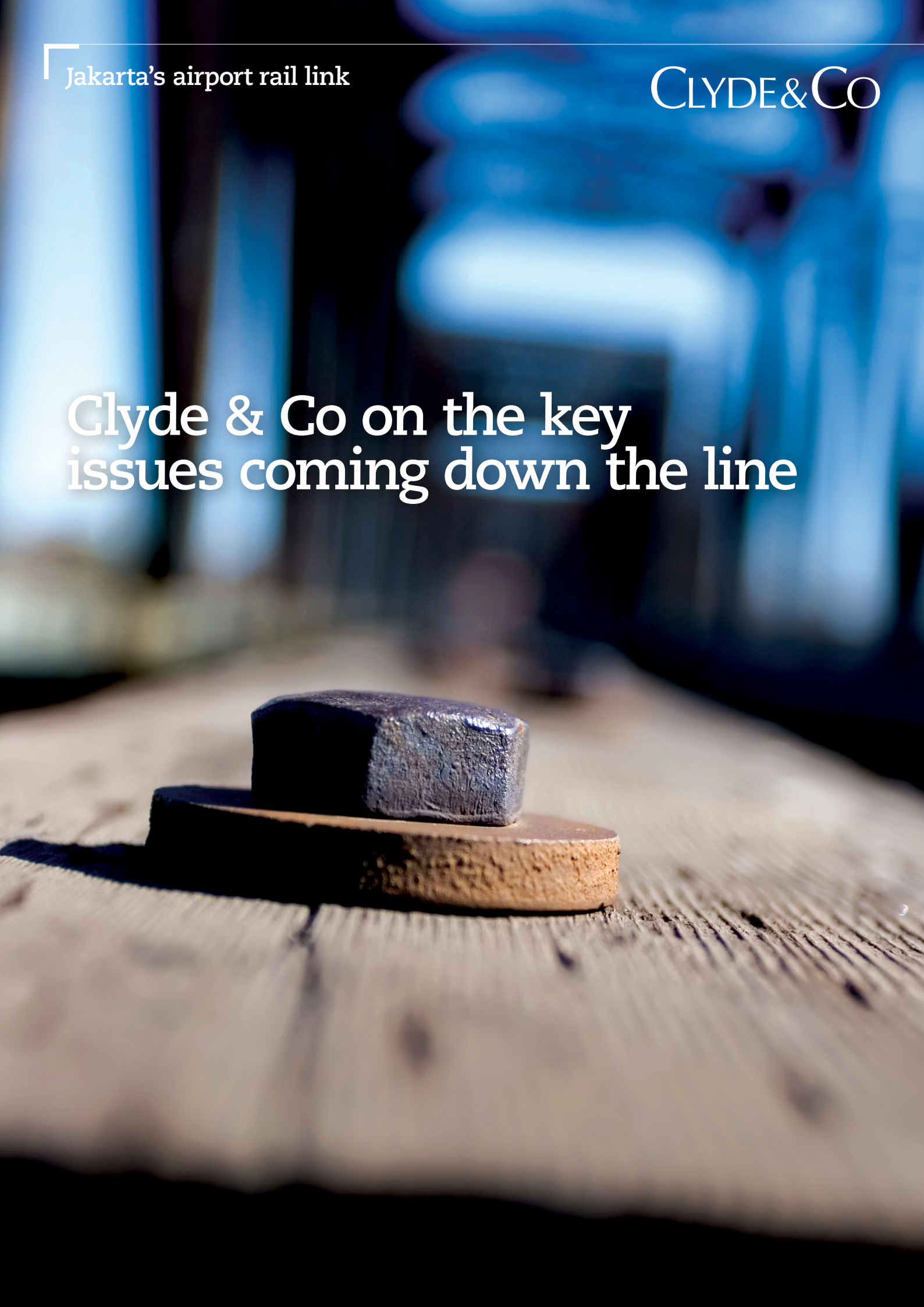


Clyde & Co on the key issues coming down the line



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Introduction

Imagine an airport that services 57 million people annually. Operating at 260% capacity, it is bracing itself for passenger numbers to swell beyond 80 million by 2030, hitting four times its design capacity.

Now place that airport 20 kilometers from a booming megacity on the world's most densely populated island. Connect that airport to the city with a single highway built on a partially submerged tidal plain that regularly floods. Throw legendary traffic jams into this mix.

That airport, **Indonesia's Soekarno-Hatta Airport (SHIA)**, services Jakarta, the nation's capital city located on the western end of Java island. The 9th busiest airport in the world, SHIA moves more passengers than Dubai, New York-JFK, Singapore or Hong Kong airports.

After years of steadily worsening access to the airport, the Indonesian government is poised to address the issue, with major transport projects in the works. Planned rail lines proposed to link SHIA with downtown Jakarta promise relief. No longer should the trip from SHIA into the city take more time than some domestic flights arriving at that airport.

With public information about the project in scarce supply, Clyde & Co's rail experts receive frequent requests to share our insights. In response, we offer the following discussion of some key issues – the PPP approach, land acquisition, planning and participation, direct State funding, compensation on termination, and security and service issues.



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Two projects,
fast and slow

The project is actually two projects for construction of separate rail lines. One will provide a slower commuter service and should be completed first. The other will provide a premium express service, and will take longer to realize.

The commuter line will use existing tracks that connect South Jakarta to Tangerang in Banten province and then add six kilometers of new track north to the airport. With nine stations and existing commuter traffic, the commuter line extension project will not provide express access from central Jakarta. State rail operator Kerata Api Indonesia will undertake the project in a joint venture with state airport operator Angkasa Pura II.

The second, more ambitious scheme is for construction of a new light rail line running through Pluit in the north, then heading west to the airport. The route south from Pluit is uncertain, with five different options mentioned. One potential route is proposed to connect with East Jakarta's Halim Airport. Previously Jakarta's international airport, Halim is now a military and general aviation field for which domestic commercial aviation services may be reintroduced.

The light rail express line – referred to below as the Airport Rail Link – will be undertaken as a public-private partnership (PPP) in the form of a long-term concession grant to private investors, harnessing their expertise and funding. Feasibility studies and project design efforts are underway, and public tender is targeted for 2014. Current indications are that the project will be undertaken as a unitary project, although a project of this size and type might benefit from disaggregation into more manageable parts, such as by splitting the rail and other facilities from the operations, and offering both as separate PPP projects.

The PPP approach – necessary, but uncertain

The Airport Rail Link will rely on a sound, but untested PPP regulatory framework. The Government's budget constraints, including a legally-mandated national deficit limit of 3% of GDP, drives a PPP bias to a majority of Indonesia's huge projected infrastructure spend. The Government must also be mindful of investment demands from poorer regions that have long endured a national bias toward national budget expenditures that favor capital city Jakarta.

Given an estimated cost of approximately USD 2 billion, we believe that political considerations assure that no Government wants to be seen to foot this bill alone. The project will benefit middle class fliers who swap private car usage for the comforts of an air-conditioned express rail service. Regions short on power, clean water and other necessities may not agree that significant funds should be dedicated to this convenience.

Indonesian PPP regulations are sound, straight forward and designed to establish some fundamental principles, such as feasibility assessment, open tendering and appropriate risk allocation. They reflect local experience with PPP projects, which began in the early 1990s.

Those early projects typically were unsolicited bids for which there was no competitive tender. Often with little in the way of feasibility studies and insufficient attention paid to risk allocation and government support, project companies grabbed concessions and then sought to shop them to investors and financiers. Many projects were ill conceived, and many were never financed.

Indonesia's PPP regulations were meant to stem the flow of unsolicited, unfunded and under-structured transactions and replace it with competitively bid projects that would be technically and financially sound. The first PPP rules (Presidential Decree No.7/1998 and related regulations, drafted by this author, Clyde & Co's Michael Horn) were issued in 1998, just prior to the end of Soeharto's long tenure as President. These rules assumed central government authority for PPP projects, and the regional autonomy and decentralization that followed the Soeharto era made this approach immediately obsolete. Subsequent (and very similar) iterations of these rules were issued in 2005 and 2010, supported by related laws and regulations on matters such as land acquisition, Government guaranties and establishment of Government-sponsored champions Sarana Multi Infrastruktur, Indonesia Infrastructure Guaranty Fund and Indonesia Infrastructure Finance.

16 years after Presidential Decree No.7/1998, few projects have been built under the PPP rules. In particular, no PPP rail project has ever been built in modern Indonesia.





Private Rail Redux

Private rail development is not new to the country, but given its current novelty and untested nature, it may as well be. The State's role in rail development has always been central.

The country's first rail line, completed in 1867, was an entirely private undertaking of the Netherlands East Indies Railway Company. That company also developed the first commuter line, linking Jakarta (Batavia) to Bogor (Buitenzorg) in 1873.

From its infancy the Indonesian rail sector revealed the central importance of State support. That first rail project began life as a privately-financed commercial venture, but the Dutch colonial administration soon assumed funding of the underperforming project, paying for the extension of the Semarang line to Jogjakarta, Central Java.

Since the armed forces of the newly-independent Republic of Indonesia assumed control of some rail lines in September 1945, the Indonesian government has been the sole player in the sector, acting as owner, developer and operator of the entire network and all rolling stock. After more than 60 years of expansion from its founding in the 1860s through until the 1930s, the Indonesian rail network has suffered 70 years of shrinkage and stagnation under public administration.

Indonesian state management can claim some early major successes. The severely war-damaged network and rolling stock were rebuilt in the early 1950s. Diesel-ization moved the country away from steam locomotives.

However, the network shrank. Java's extensive light rail "tramways", used for urban transport, feeder lines and agricultural transportation, have all disappeared (with the exception of the Purosari-Wonogiri line near Solo, Central Java). Network abandonment in the 1970s and 1980s included the Aceh and West Sumatra systems and nearly all of Java's feeder lines.

The Airport Rail Link will be the first light rail project in Indonesia since the Java tramways were completed a century ago. The Airport Rail Link will also be the first Indonesian passenger rail project of the modern era that is driven by private investors and financiers. Other projects proceeding in parallel will feature private sector participation, but deviate from a pure PPP model because they will be funded by state borrowings (Jakarta MRT) or are not passenger oriented (the commodities-focused Central Kalimantan rail project).



Land acquisition
– a perennial
problem that has
not been solved

Land acquisition difficulties have long been an impediment to Indonesian infrastructure projects. With powers of compulsory purchase or acquisition (“eminent domain” in the United States) confirmed and improved by recent legislation, the Government has the authority to seize land, as long as it pays for it. Finding the funds to do so is the next challenge.

Both the amount of land required and the location of the land can give rise to disagreement. The Airport Rail Link will be located in urban areas, with the tracks laid in densely populated areas on valuable, scarce land. These characteristics point to a fundamental tension between competing interests that is common globally to essential public service infrastructure projects.

In developed economies with well-developed land title systems, this tension arises from competing uses that typically pit the interests of the community in fostering infrastructure development against the private property interests of individual owners. In Indonesia, matters can be substantially more complicated by the presence of a third set of interests, those of the local community.

In Indonesia, private owners of certificated land appear to have held the upper hand in recent years. The Government has been unable or unwilling to exercise powers of compulsory purchase to seize private land for public purposes. Toll road projects in particular are plagued by land acquisition delays.

Indonesia’s new Land Acquisition Law (Law No.2/2012, and its implementing regulations) was received as the great panacea that would resolve these issues, facilitating public land seizures by eliminating private owners’ legal rights of action to prevent land seizure, while safeguarding their legal rights to just compensation. (Recent discussions of the Land Acquisition Law routinely overlooked that the Government has long held powers of compulsory

purchase. First introduced by colonial authorities in 1870, the State’s powers to seize land for public purposes has been reaffirmed in different legislative forms in 1960, 1961, 1975, 1993 and 2005.)

Despite the new Law’s promise, land acquisition issues remain a central challenge to the Airport Rail Link’s success. The primary issues are scope of application, timing and cost.

We are confident the Law will apply to the Airport Rail Link, which appears on its face to be classifiable as a public interest development that benefits from the Law. The Land Acquisition Law empowers land seizure in the “public interest”. While this term is not defined, land seizures through the State’s exercise of compulsory purchase rights are expressly allowed in order to promote the public interest for certain categories of development, including “railway, train station and train operating facilities” (Article 10).

Importantly, development in the public interest includes activities carried out with the involvement of the private sector, not just development activity undertaken by the State. Compulsory surrender of land will apply to land required to build eligible PPP projects. Owners may challenge the compensation offered, but may not block the land seizure when it is in the public interest and for a permitted development.

The Law imposes time requirements that offer certainty, but does not promise speedy project execution. The acquisition progress may be as long as 583 days. National oil company Pertamina has publically complained that the Law will actually prolong delays, rather than resolve them.

Costs remain an issue. Simply possessing the right to seize land against payment of just compensation does not assure the State has the funds to pay that compensation. One recent report cites the impact of land acquisition costs on the project's forecasted budget as a primary cause of the Airport Rail Link's delay, pushing groundbreaking back to at least late 2014.

Timing restrictions, imposed by laws and regulations, put huge upfront land costs on the State and preclude use of private funding and project finance techniques. Funding for land acquisition can come solely from the national/regional budget or the budget of a State-owned enterprise, and land is handed over only when compensation is actually paid. Unless 100% of the land is acquired, a project may not progress from the preparation stage – the Airport Rail Link's current status – to the transaction stage, when a private party enters the picture.

Only then can additional funding from private sources be used to bolster State funds. Before then, no joint funding may be provided by the private sector. Any compensation paid by private parties to the State to reimburse for land expenses follows after PPP bid selection, contract negotiation and financial close, long after land acquisition funds were needed and paid out.

This reliance on State funds prior to use of private funds highlights the importance of the State's Land Revolving Fund (providing bridge funding for land purchases, later repaid by a project winner) and Land Acquisition Fund (for purchase of land to be contributed by the State as a form of viability gap funding). The sufficiency and performance of these new funds cannot yet be evaluated.

Clyde & Co believes land acquisition structures might be developed to address these issues and relieve the State of its financing burden. For example, a theoretical structure we have framed would have the Government enter into options to purchase land from private owners. The options would be obtained by the Government before the project is put out to tender and would be held by the Government. The options would be exercisable by the Government, but at a time selected by the private sector project company. The project company would time the land purchase for when the land is required and provide the necessary funds to pay sellers in lieu of the Government paying for the land. In this manner the Government would not be called upon to finance land purchases for private parties.

While creative approaches of this kind can be structured, we suspect they will not be used for the Airport Rail Link. Alternatives to Government compulsory purchase may not fit comfortably under the Land Acquisition Law. Moreover, we can foresee controversy and protests if landowners are given a fixed option sales price long before the option is exercised, and by the exercise date land prices have risen dramatically.

Clyde & Co believes that land seizure by exercise of compulsory purchase rights by the State will be essential to the progress of the Airport Rail Link. We note that that the rail route naturally needs to be settled before land can be acquired. We expect that the Land Acquisition Fund and the new Land Acquisition law, each relatively untested, will be used for this purpose.

Planning and participation – meet your new partners

The Airport Rail Link will rely on numerous stakeholders whose interests must be accommodated. Project design and investment and ownership structures may reflect this fact.

The project will run through areas under the authority of the Banten provincial government and of the Jakarta provincial government (DKI Jakarta). Rail track will run through three or more of DKI Jakarta's five constituent municipalities, North, West, Central, South and East Jakarta, each of which has its own mayor and related bureaucracy. Banten is divided into regencies and municipalities, each with local leadership, authority and interests.

A long history of lobbying for alternative route proposals suggests local interests have been weighing in. This author participated in some of these discussions nearly four years' ago, and more recent reports show the issue has a tenacious hold. With multiple stations planned (investment authority BKPM advertises six) and local authorities competing for one of them, observers have worried the express service promised by the project may be compromised.

State-owned enterprises may also act as stakeholders with interests to further. State-owned Kerata Api Indonesia (KAI) is Indonesia's sole authorized operator of railways. Absent a change of law, KAI is assured of a role in the Airport Rail Link. Law No.13/1992 on Railways permits KAI's cooperation with private parties in the operation of rail systems, and presumably the tender of the project will offer KAI as a partner to any successful bidder. A threshold issue for bidders will be the nature of such cooperation and the degree to which KAI intends to play an active role in operations.

While less certain, Clyde & Co believes State-owned airport operator Angkasa Pura II is also a possible participant in the project. As operator of SHIA and holder of land use rights needed for rail rights-of-way and the

SHIA train station (and possibly the rail yard), Angkasa Pura II's cooperation must be secured. As noted, this company has already invested in the airport commuter rail joint venture with State rail operator KAI.

Indonesian PPP projects generally follow a concession-grant model similar to the Private Finance Initiative (PFI) approach spearheaded in the United Kingdom and replicated in Australia and elsewhere. Nevertheless, Government officials routinely take a broad view on the role of Government as a partner in a Public-Private Partnership.

This author previously served as Transportation PPP advisor to the Indonesian Department of Transportation and as Chief Risk Officer of Indonesia Infrastructure Finance. In such role I many times encountered Government officials who supported an active role for State-owned enterprises and local governments as equity investors playing an active role in operations. For these officials, PPP does not mean the Government is a concession grantor. Rather, they see the State as a full business participant.

A project company equity holding for Kerata Api Indonesia and/or Angkasa Pura II (or even local government-owned enterprises set up for this purpose) would not come as a great surprise to us.

We also note that Kerata Api Indonesia purchases rolling stock from PT Industri Kerata Api, a state-owned manufacturer of rolling stock (excluding locomotives). A supply role may be reserved for this company.



The competitive landscape

Odd as it seems, it will be a challenge for bidders to predict traffic demand for the Airport Rail Link. Airport passenger numbers are high and air travel will grow as national wealth swells, but competing airports may be built and the commuter rail project servicing SHIA will directly compete with the Airport Rail Link.

Demand uncertainty will suggest the need for investors and financiers to mitigate demand risk. Private parties may actually welcome greenfield demand risk if it encourages Government's payment of an availability charge to transfer demand risk to the State. However, in past projects the Government has not offered availability charges. Based on numerous discussions, our view is that the Government's current unwritten policy is to avoid availability charges and to place demand risk on private parties.

Paradoxically, one source of demand uncertainty is rising demand for air services. Soekarno-Hatta Airport cannot manage much beyond its current passenger load unless a third runway (part of the original airport design) and a fourth terminal are constructed. There are no current plans to build these new facilities, although the idea surfaces frequently. An expansion of existing facilities is currently underway and targets capacity of 62 million passengers per year. SHIA is currently operating at 57 million passengers per year, leaving little headroom.

In 2010 the Government and foreign interests, principally Japanese, started a dialogue on the need for one or more additional airports to serve Greater Jakarta. On Japan's initiative, the Government has floated the concept of a new airport in Karawang, east of Jakarta. The Japan International Cooperation Agency (JICA) has been a prime mover behind this concept, developing it within the framework of 2010's Japan-Indonesia Memorandum of Cooperation defining a "Metropolitan Priority Area" for investment and industry. JICA has since prepared a Master Plan Study on Multi-Airport Development for Greater Jakarta and a pre-feasibility study for the Karawang International Airport (KIA).

When all stages are completed, KIA would be capable of handling 70 million passengers. Preliminary signs are that KIA, if developed at all, would be rolled out in stages, starting with a first phase that can handle up to 20 million passengers per year. This progressive roll-out and uncertain passenger ramp-up would add complexity to demand modeling for the Airport Rail Link. Some airlines

have indicated preliminary support for the Karawang International Airport as a concept, and national carrier Garuda Indonesia even floated the possibility that KIA would serve as its new hub.

However, it is far too soon to predict how much traffic would be diverted to KIA and what impact this will have on the passenger load at Soekarno-Hatta Airport that forms the potential passenger pool for the Airport Rail Link.

The KIA project is far from certain. The project initially encountered resistance from the West Java Provincial Government, as it had acquired land for a new airport at Kertajati, not far from the Karawang site. Recent statements suggest Government now supports both airport projects. However, this may only be a temporary compromise, and neither project is much more than a concept on paper. Reading the tea leaves from often contradictory public statements and our private discussions, our view is that the hard choice between Karawang International Airport and Kertajati Airport has been deferred. If both KIA and Kertajati Airport proceed, the two projects may tap the same passenger pool, although Kertajati in part targets Bandung traffic.

Other less developed plans further cloud the traffic picture. An idea has been floated to build a new airport on a reclaimed island in Jakarta Bay. The project seems to have been championed by Jakarta City's prior administration and appears to be little more than a "blue sky" concept. We have heard nothing of it since Jakarta's new mayor took office last year.


Halim Airport, very close to Jakarta's city center, was one of Jakarta's main airports until the 1980s. Now used exclusively by the Air Force, there are plans to re-introduce limited domestic services. It appears to us that there is no serious current plan to expand commercial usage sufficient to affect passenger loads at Soekarno-Hatta Airport. We note, however, that one of the proposed routes for the Airport Rail Link would extend to Halim Airport in the east. Perhaps somebody with a planning role foresees a material role for Halim as a competing airport.

As noted above, the Airport Rail Link is only one of two proposed rail projects proposed to improve access to SHIA. The other project, an extension of existing commuter services, will be undertaken by State enterprises. Our assessment is that this commuter project has a good chance of being completed sooner than the Airport Rail Link, as it will use existing facilities, require less investment and land acquisition, and will not be complicated by competitive tender.

This commuter project may not have a substantial impact on demand for the Airport Rail Link services. The catchment area for users serviced by this commuter project will probably not include a large part of the Jakarta population that we expect will be targeted by the Airport Rail Link. However, until the Airport Rail Link route is finally decided, this conclusion remains tentative.

Moreover, unless there is substantial improvement to current standards, the class of service provided by commuter services will not appeal to travelers targeted by the Airport Rail Link, who are solidly middle class and sufficiently wealthy to currently access SHIA in the comfort of a private car or taxi. However, bidders are advised to carefully consider whether the commuter line might relieve road congestion to the extent that taxis, buses and private cars become more attractive and compete against the Airport Rail Link.

Assuming that the Airport Rail Link will transfer revenue risk to the private sector, sponsors and funders will want traffic forecasting that takes into account both the new commuter line and the prospect of additional Greater Jakarta airports. Given that none of these will have been built when the Airport Rail Link is put out to tender, these rail and airport projects, and the probability of their completion, will add a layer of complexity and uncertainty to the forecasting that is central to a bidder's determination of tariff and State support levels in its bid. When framing reasoned assumption of projected traffic Bidders must recognize that the bidder who assumes the most optimistic traffic forecast may put forward the most competitive bid, but runs the risk of relying on the most inaccurate traffic projections.



Viability gap funding and operating period support

Clyde & Co expects substantial State funding of the Airport Rail Link. As urban rail projects repeatedly show, capital expenditures cannot be funded solely out of future fare revenue, and optimal fare levels often generate revenues that fall far short of operating expenses.

Recent construction and land cost estimates for the Airport Rail Link are close to USD 2 billion, a number that may increase given ever-rising land costs. This figure is nearly double the original estimates. Operations and maintenance expenses will also be sizeable.

We believe State funding support will take the form of viability gap funding of capital expenditures. As noted below, this gap funding will likely cover less than half of all capex. State funding support may (and in our view should) also include land contribution (funded by the Land Acquisition Fund, established for this purpose). State funding support may (and in our view should, but very well may not) include either a subsidy (such as a minimum revenue guaranty) to augment operating revenue or an availability charge paid by the Government. We reach these conclusions based on the Airport Rail Link's characteristics, not our perception that the Government is inclined to offer substantial support. Bidders who relieve Indonesia of funding support demands will naturally have an advantage. Alternative support given by national agencies of a bidder's home country, such as export credit agencies, long-term state lending institutions or overseas development assistance providers not surprisingly will be welcomed.

Neighboring countries' urban rail systems provide evidence of the importance of State capex funding. Hong Kong's MTR was state built and has long relied on income from the sale of valuable land for non-rail purposes. Singapore's MRT relies on state funds for line construction. Taipei's system remains wholly public.

Direct funding is subject to new Viability Gap Funding (VGF) regulations (Minister of Finance Regulation No.223/2012). Under the VGF Regulations, VGF may be provided only in the form of direct funding of a part of construction costs. These costs may include equipment

cost, installation cost and interest costs during the construction period. (Covered costs exclude any costs relating to land procurement and tax incentives, but these forms of support can be offered by the Government under other regulations).

To receive VGF the project must be "economically feasible" (an imprecise, untested term from new legislation), but not financially viable without the VGF support. Additionally, there must be a minimum project value of INR 100 billion (USD 10 million), and the quantum and structure of the support must be optimized as per a feasibility study analyzing risk allocation between the private and public sectors.

Further, the amount of VGF funding cannot "dominate" the financing of the project. This has been taken to mean that not more than 49% of the construction costs of a project can be financed via VGF, but this may be open to debate. If VGF funding is offered in a tender, it appears that the bidders will be assessed solely on the level of VGF they require. (Presumably this assumes bidders are offered a fixed, non-negotiable tariff and that they are separately assessed on technical merits.)

Clyde & Co believes the Government should view VGF funding, land contribution and support for operating revenue as investments costs that are justified through use of one or more analytic tools. These would include a public sector comparator model (to compare the cost of State support to the cost of Government's procurement of this project), an economic investment model (to

estimate the economic benefits generated by these costs) or an economic costs model (to estimate the economic costs if there is no project built). We can confirm that these concepts are discussed and understood at the highest levels of Government. However, our most recent discussions confirm that these analytical models have not yet been adopted as part of a formal process to determine State support across a range of projects. State support remains a factor determined on a case-by-case basis.

We believe VGF funding and land contribution, if given, should be viewed by the Government as sunk costs that the Government will not recover directly out of the project during the expected concession period of the Airport Rail Link concession. This is typical for rail project capital costs, which are unavoidably very high.

For example, Clyde & Co believes that globally only two high speed rail links have ever earned back their construction costs since start of operation, Tokyo-Osaka (completed in 1964) and the TGV line in France between Paris and Lyon (completed in 1981). We note that both charge premium fares for long distance, high speed services that price compare against airplane fares, not taxi fares. Additionally, each project managed this result only because it has been in operation for over 30 years, presumably longer than the PPP concession tenor to be proposed for the Airport Rail Link.

We also believe that financial support from the Government during the operating period may be required to make the project operationally viable. Even with studies showing passengers will pay more for an Airport Rail Link ticket, we assume the project's Farebox Recovery Ratio (fare revenue to operating expense) will fall materially below 1. (Note that we have not run any financial models in this regard.) This places the project in the company of European and North American MRT systems that require continuing government operating subsidies, not that of operational profit-generating or break-even systems like Tokyo Metro, Hong Kong MTR and Singapore MRT. In reaching this conclusion, we assume low fares reflecting current income and GDP levels, fare levels no higher than those in neighboring, wealthier countries (USD 0.06 – 0.15 per km) and low pricing of alternatives (currently below USD 4 per person in a full taxi from downtown Jakarta to SHIA).

Compensation on termination

Indonesia has long viewed with suspicion requests that it pay compensation on concession termination. Recent developments suggest the Airport Rail Link bidders may be promised a modified form of compensation on termination, providing useful, but less than optimal, protection for financiers and investors.

The Government generally seeks to avoid promising compensation on termination, and appears to view this as a form of guaranty. Having lost two geothermal arbitration claims brought during the Asian Financial Crisis, Indonesia developed an allergy to paying investors when they exited failed projects.

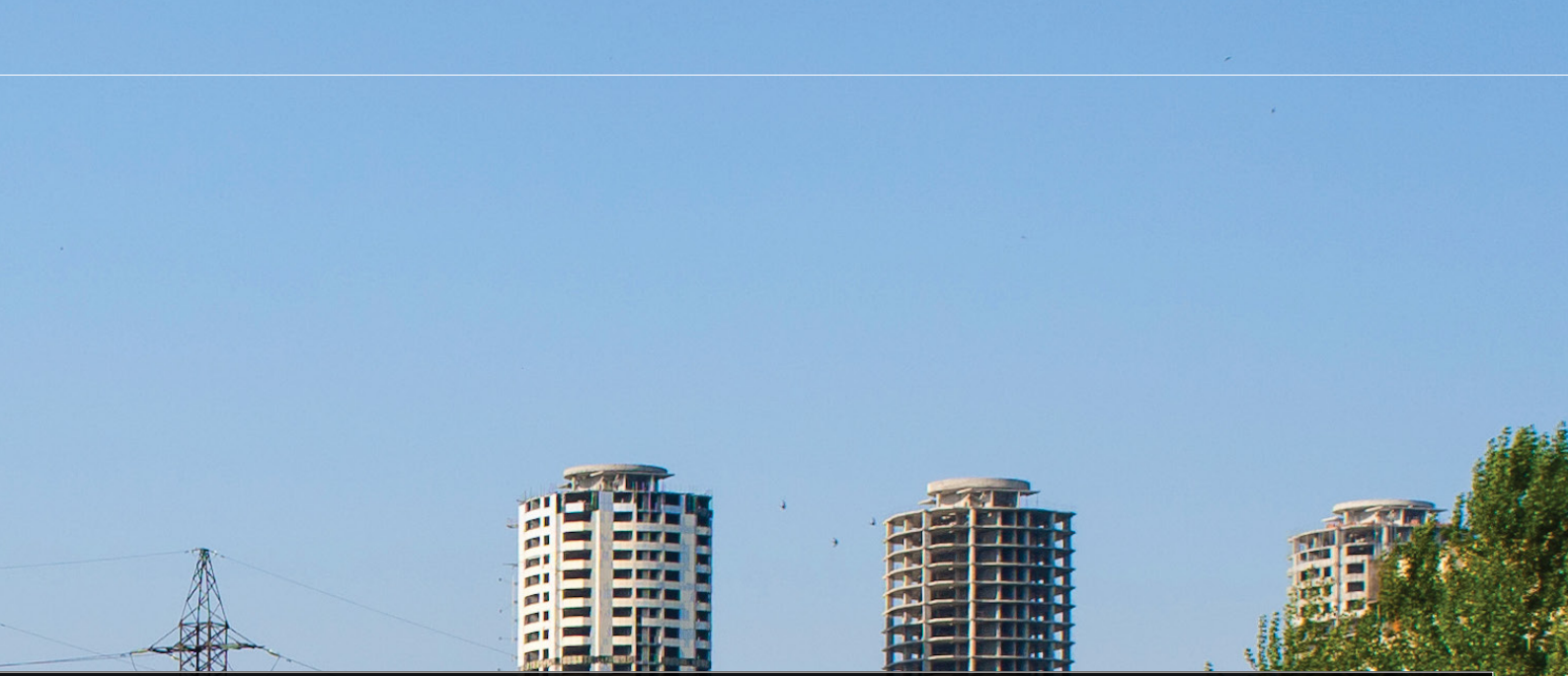
In light of recent treatment in concessions, and after many discussions, we conclude the Government remains wary of compensation on termination. It appears not to have fully accepted that it is both fair and desirable that it pay compensation on termination. Having been advised that such payments are standard to infrastructure markets in

other countries, the Government appears hopeful that its projects are suitably attractive to avoid promising such payments. However, recent experience in the restructuring of a toll road concession, discussed below, suggests that the Government may have seen the light and accepted that some form of compensation on termination is unavoidable.

Compensation on termination paid by the State is important for the simple reason that banks and investors with exposures to the Airport Rail Link will want to know they will be repaid their monies if the Government terminates the concession contract. Because the concession contract grants the right to operate the project and generate revenue, if the concession is terminated the project assets will have limited value for the lenders and investors. The rolling stock and switching gear, for example, will not be removed from Indonesia and sold elsewhere.

The project's assets will only have value to parties empowered to own and operate them, and Government firmly controls who that owner/operator will be and what they will be permitted to earn from the assets.

Clyde & Co has consistently advocated before government officials for compensation on termination that fully covers senior debt in all circumstances and that provides investors a full equity pay-out with an agreed return on equity in most circumstances. A limited exception should



be made for a project company that is in default, which should receive back the investment made, but with no return on equity.

This approach is desirable because financiers that are assured they will always get their loans repaid by an investment grade government may lend when they otherwise would not have, and will lend for longer periods, in larger amounts and at cheaper rates than they otherwise would have.

Compensation on termination is fair because, from the lenders' and investor's point of view, when the contract is terminated, the Government should buy the project. The investor's project company owns land and project assets that it cannot use. However, as the Government is not the owner, it cannot use these either. This result – unused stranded assets that are material to provision of an essential service – is not good for Government, for the owners, for the lenders, and importantly, for the public.

In such circumstances it is better for the Government to take over the Airport Rail Link, with payment of compensation on termination actually serving as the Government's purchase price to buy the project. It can then choose to re-sell the project to other private parties or own and operate it for itself.

The Government benefits from the project's easier access to attractive funding and by defining its right to take over a project and the cost of doing so. The Government might

also welcome a clearly stipulated contingent liability for payment of compensation on termination because it may act as a cap restricting the size of claims that might be brought by investors in arbitration actions under bilateral investment treaties.

A useful but unsatisfactory solution was developed by the Government to promote recent restructuring of a stalled toll road project. Clyde & Co believes this approach may feature in the Airport Rail Link. That approach would see the Government agree to pay compensation on termination, but only after a 18-month period during which the banks, and then the Government, try to sell the project to a new private investor.

We have previously advised that any bank or investor offered this provision will need to assume in its financial model that it will not be fully repaid for 18 months. The "negative carry" cost of equity and debt during this period will put a drag on the project revenues in the financial model and may not be compensable through the fare structure, which presumably is both regulated and set to reflect demand elasticity.





Accommodating
security and
service issues
into design,
construction,
operations and
maintenance

As the Airport Rail Link will connect with a major international airport inside the airport facility, security issues will form a major consideration. Additionally, the criticality of the services provided by the airport, and the special standards required to maintain operational safety of both the air and rail services, will require careful attention.

Drawing on our global experience in the rail, aviation and construction sectors, Clyde & Co notes below a non-exhaustive list of further factors that will impact of design, construct and operation of the Airport Rail Link.

Security concerns on the train and in the airport and train stations will be of paramount concern. The Airport Rail Link's design will need to incorporate mechanisms for swift closure of the service in the event of emergency situations at the airport, including the facilities to permit trains en route to return to the embarking station without disembarking their passengers. The construction program will need to reflect that airport access is particularly restrictive for security reasons. Output specifications for operations and maintenance services will need to accommodate security procedures.

Track and facility design should allow for the rolling stock to be removed from the track both to facilitate track maintenance and to allow for rolling stock maintenance. Given limited land availability in Jakarta, rail yard facilities may be located on airport land and be subject to airport security procedures.

The project company's development activities will need to minimize disruption to ongoing airport operations. In Clyde & Co's experience, this goal may have a significant impact on construction programs. The contractors may have only limited possession windows for any work required in the airport area itself, and this may require daily removal of equipment and reinstatement, adding to construction time and cost. Similar access issues may affect maintenance regimes during the operating period.

Service interruptions during rail operations will have added criticality if they lead to missed flights. However, we expect this consideration would probably not be give rise to project company losses through the performance regime. We note that this risk may be reduced given that Airport Rail Link will an entirely new-build and self-contained project, and should have limited interface with the rest of Indonesia's rail network.

The commuter rail project undertaken by KAI and Angkasa Pura II will service the same terminal station at SHIA, so Airport Rail Link service disruptions and performance failures resulting from actions or events related to the commuter rail project should not penalize the project company. Joint use of the airport rail station and other facilities will require a separate regime of rules, procedures and allocation of risks and liabilities, and a consultation and rectification regime will be needed to address service outages arising from use by other parties.

Similarly, the Airport Rail Link's design might seek to incorporate remote check-in facilities at the embarking station. These facilities would be occupied and operated by third parties and will be subject to a separate regime of rules, procedures and allocation of risks and liabilities.

Design coordination will be important to properly integrate the rail and airport facilities. For example, passenger flow, way-finding and signage between the SHIA station and the SHIA arrival and departure facilities will require coordination between the project company and the airport operator Angkasa Pura II.

Ancillary revenue generation from retail and property development can be an important source of revenue support for a mass transit system. For example, the Hong Kong MTR relies heavily of property development revenue, and the Taipei MRT derives approximately 15% of its revenue from advertizing and other non-rail activities. Soekarno-Hatta Airport currently yields about 20% non-aeronautic revenue, whereas the global norm is just below 50%. We expect SHIA will seek to increase its retail revenue, and we note retail expansion plans announced recently by Angkasa Pura I, the sister company of SHIA's operator Angkasa Pura II. Retail development opportunities at the SHIA rail station may be constrained by limits imposed on competition with SHIA's retail operations.

Closing

The foregoing analysis highlights only some of the issues Clyde & Co expects to arise in respect of the SHIA Airport Rail Link project. While Clyde & Co has gathered substantial information on the project through frequent meetings in Jakarta and elsewhere with Government representatives and agencies, advisors and private parties, it is clear to us that other materials issues will emerge to challenge the project's execution.

Clyde & Co is available to discuss the project with interested parties, and encourages you to contact us for that purpose.

We also invite you to register with us to receive further bulletins from us on the Airport Rail Link project.



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Clyde & Co's experience in Indonesia stretches back to the early 1970s, when one of our senior lawyers, then Pennzoil's General Counsel, advised on one of the first Production Sharing Contracts in Indonesia. Today, the partner leading our Indonesian practice is Michael Horn, an Indonesian market veteran who since 1992 has advised Indonesian and offshore clients on some of the most significant transactions in Indonesia.

Our Indonesia practice group includes native Indonesians who have practised in both domestic and international law firms in Indonesia. A number of our lawyers in the team are qualified in the country and can draft and review documents and negotiate in Bahasa Indonesia.

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