ASIAN DEVELOPMENT BANK **RRP: INO 32517**

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED LOAN

TO THE

REPUBLIC OF INDONESIA

FOR THE

STATE-OWNED ENTERPRISE GOVERNANCE

AND PRIVATIZATION PROGRAM

November 2001

CURRENCY EQUIVALENTS

(as of 5 November 2001)

Currency Unit	–	Rupiah (Rp)
Rp1.00	=	$10,770
$1.00	=	0.000093

The exchange rate of the rupiah is under a system of a free float

ABBREVIATIONS

ADB	–	Asian Development Bank
BAPEPAM	–	Badan Pengawas Pasar Modal (Capital Market Supervisory Agency)
BAPPENAS	–	Badan Perencanaan Planning Agency (National Development Planning Agency)
BOC	–	Board of Commissioners
BOD	–	Board of Directors
BPKP	–	Financial and Development Supervisory Board
DG BUMN	–	Badan Usaha Milik Negara (Directorate General for SOEs)
DSAK	–	Dewan Standar Akuntansi Keunangan (Financial Accounting Standards Board)
EVA	–	economic value added
FGR:SDP	–	Financial Governance Reforms: Sector Development Program
GAAP	–	generally accepted accounting principles
GDP	–	gross domestic product
IBRA	–	Indonesian Bank Restructuring Agency
IAS	–	International Accounting Standards
IIA	–	Indonesian Institute of Accountants
ILO	–	International Labour Organization
IMF	–	International Monetary Fund
INDRA	–	Indonesian Debt Restructuring Agency
IPO	–	initial public offering
IPTN		Indonesia Aerospace Industries
JITF	–	Jakarta Initiative Task Force
JSE	–	Jakarta Stock Exchange
LIBOR	–	London interbank offered rate
KKN	–	Corruption, Collusion, and Nepotism
LOI	–	Letter of Intent
MBO	–	management buy-out
MOF	–	Ministry of Finance
MOM	–	Ministry of Manpower
MSOE	–	Ministry for State-Owned Enterprises
NCCG	–	National Committee on Corporate Governance
PLN	–	Perusahaan Listrik Negara (State Electricity Corporation)
PSO	–	public service obligations
SBSI	–	Indonesia Properous Workers' Union
SCI	–	statements of corporate intent
SME	–	small- and medium-sizes enterprise
SOE	–	state-owned enterprise
SOEGPP	–	State-Owned Enterprise Governance and Privatization Program
SPSI	–	All Indonesian Workers' Union
SPSI-R	–	All Indonesian Workers' Union - Reformation
TA	–	technical assistance

NOTES

In this report, "$" refers to US dollars.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower The Republic of Indonesia

The Proposal Support to the Government for the State-Owned Enterprise (SOE) Governance and Privatization Program through a program loan of $400 million.

The Program

Rationale SOE performance in Indonesia has been affected by weak corporate governance such as Government interference in day-to-day operations, poor internal controls, loopholes in accounting practices, and weak auditing standards and practices. Lax supervision and insufficient accountability have distorted performance incentives for supervisors and staff. Inadequate enforcement of commercial laws and regulations, market protection, and administered prices have contributed to ineffective SOE management.

Though established to serve both economic and social goals, SOEs have been inefficient suppliers of both public and private goods and services. The provision of social services and contribution to regional development objectives has largely been achieved at a considerable cost to society. Inefficiencies arose because of indiscriminate subsidization and protection of SOEs without due regard for economic rationale and competitiveness. Moreover, there has been a high degree of exploitation of SOEs for the benefit of individuals and their associated interests, accompanied by growing corruption and collusion or outright fraud. This weak governance in the Government's sphere of influence encouraged violations of rules and regulations in the private sector, to the detriment of creditors and minority shareholders.

SOEs' reliance on two-step foreign currency loans that they received in local currency has significant long-term budgetary implications. Under the standard on-lending arrangements, the Government carries the full exchange rate risk on both interest and principal for SOEs' borrowings. In addition, substantial amounts of capital injections and debt foregiveness have diverted resources from addressing social development priorities. Overall, the costs of holding onto the portfolio of SOEs are significant. Besides opportunity cost of capital, the past practice of two-step loans will burden the state budget with at least $1.1 billion (Rp11 trillion) per year during the next decade. The direct costs of nonperforming loans from the Ministry of Finance (MOF) to individual SOEs is estimated to amount to $300 million (Rp3 trillion) annually. This amounts to a total of about $3.9 billion (Rp39 trillion) of actual and opportunity costs of the SOE portfolio, and does not yet count future debt-to-equity swaps, loan foregiveness in the context of Indonesia Bank Restructuring Agency (IBRA) debt restructurings, and liquidations. This total cost of $3.9 billion (Rp39 trillion) is equal to four times the expenditure for housing and human settlement, five times the expenditure for education, and eight times the health expenditure.

Despite protection, subsidies, preferential access to public funding, and guaranteed access to foreign lending, investments in SOEs have yielded suboptimal returns. While subsidization of SOEs has been scaled down due to fiscal pressures, many SOEs have raised additional debt or stopped servicing their debt obligations to cover operational losses and meet day-to-day obligations. This mismanagement avoids tough measures in the nearterm, but it raises the long-term cost of SOE reforms.

Objectives and Scope The proposed Program will improve resource allocation in the public sector, increase profitability of Indonesia's SOEs, and promote private sector participation in all commercial activities of SOEs. Reform of SOEs, involving transfer of ownership and management, and confining the Government's role to improving the policy and regulatory framework, will release scarce resources for poverty reduction and social programs. This will be achieved by (i) subjecting SOEs to sound corporate governance practices; (ii) separating commercial activities of SOEs from their public service obligations; (iii) restructuring and privatizing SOEs; (iv) establishing fair and transparent procedures for managing labor redundancies; and (v) strengthening and effectively enforcing guidelines for procurement in SOEs.

Classification Economic Growth

Environmental Assessment Category B

The environmental impact of the Program has been assessed to be positive.

The ADB Loan

Loan Amount and Terms A $400 million program loan is proposed from the ordinary capital resources of the Asian Development Bank (ADB) under ADB's LIBOR-based lending facility. The loan will have a 15-year term, including a grace period of 3 years, an interest rate determined in accordance with ADB's LIBOR-based lending facility, a commitment charge of 0.75 percent per annum, a front-end fee of 1.0 percent, conversion options that may be exercised in accordance with the draft loan agreement, the loan regulations, and ADB's conversion guidelines, and such other terms and conditions set forth in the Loan Agreement.

Program Period and Tranching The Government will be able to withdraw funds from the program loan account during a period of three years starting from loan effectiveness up to 31 December 2004. The loan will be disbursed in three tranches. The first tranche, equivalent to $150 million,[1] will be made available upon the Government meeting the conditions of loan effectiveness. The second tranche, amounting to $150 million, is expected to be released by July 2003 upon satisfactory compliance with agreed upon conditions. The third tranche, amounting to $100 million, is expected to be released by July 2004 upon satisfactory compliance with agreed upon conditions.

[1] Upon loan effectiveness, ADB shall be entitled to withdraw the front-end fee from the loan account, and pay itself on behalf of the Government.

Executing Agency

Ministry of Finance.

Procurement and Disbursement

In accordance with the simplified Disbursement Procedures and Related Requirements for Program Loans,[2] procurement of goods and services produced in and originating from ADB's member countries will be made with due consideration to economy and efficiency in accordance with standard Indonesian public sector procedures and normal private sector commercial practices acceptable to ADB. Disbursement of the loan proceeds will be permitted on the basis of a certification provided by the Borrower, confirming that in each year in which proceeds of the Program are expected to be disbursed, the value of total Indonesian imports minus (i) imports from nonmember countries, (ii) ineligible imports, and (iii) imports financed under other official development assistance, will be equal to or greater than the amounts expected to be disbursed during such year. ADB reserves the right to audit the use of loan proceeds and verify the validity of the certification issued by the Government with each withdrawal application.

Counterpart Funds

The counterpart funds to be generated out of the loan proceeds will be used to finance the cost of structural adjustments and activities consistent with the Program.

Risks and Safeguards

The implementation of the Program could be affected by several factors. The principal risk relates to political uncertainty and its effect on the pace of structural reforms. However, there is a firm commitment to SOE reform at the highest levels in the new Government and consequently the risk of the Program being diluted or abandoned is limited.

The second risk stems from the potential opposition of vested interests. For instance, all the members of the board of commissioners of SOEs are public servants—many of whom have limited relevant skills—for whom the monetary and fringe benefits provide a considerable income. Corporate restructuring and subsequent privatization will involve significant changes in the composition of the boards of commissioners, and hence, loss of position, income, and associated social prestige. Furthermore, many line ministries have traditionally used the SOEs as an additional source of revenue to finance part of their expenditures and have enjoyed wide ranging benefits that will be withdrawn. To counter resistance from these vested interests, the proposed system of corporate governance is designed to give management greater authority and autonomy, thereby reducing their willingness to collude with incompetent supervising commissioners. Furthermore, the new appointment agreements for directors and commissioners will radically change the incentive systems for both groups by linking incentives to actual performance.

The third risk relates to the lack of capacity within the Government to effectively oversee and monitor SOE reforms and restructuring in a timely and effective manner. In particular, MOF has no principal experience in either corporate restructuring or privatization. To address this concern,

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2 R50-98: Simplification of Disbursement Procedures and Related Requirements for Program Loans, 23 March 1998.

ADB has provided technical assistance (TA) to enhance the Government's capacity in financial and operational analysis, corporate restructuring, legal aspects of restructuring and privatization, and corporate governance. Additional TA has been approved for support of this Program to ensure continued momentum in these capacity building efforts.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed program loan to the Republic of Indonesia for the State-Owned Enterprise (SOE) Governance and Privatization Program (the Program).

II. INTRODUCTION

2. After a protracted period of political uncertainty, on 23 July 2001, Parliament elected Megawati Sukarnoputri as the President who appointed a new Government (the Government) and Cabinet team. This is the third change of leadership in Indonesia over the last 4 years (1998-2001) after the 32 years rule of President Soeharto. Recognizing the urgency of restoring public and investor confidence, within a month, the Government was able to reach an agreement on the letter of intent (LOI) and supportive Memorandum of Economic and Financial Policies with the International Monetary Fund (IMF). Arrangements are under way to hold the Consultative Group Meeting for Indonesia in November 2001 and the meeting of the Paris Club to negotiate the rescheduling of Indonesia's debt.

3. Indonesia, like other regional economies, managed to achieve a degree of economic recovery as real gross domestic product (GDP) grew by 4.8 percent in 2000. However, the country faces significant challenges and has yet to fully reemerge from the severest effects of the economic crisis, when GDP declined by 13.7 percent in 1998 and real wages and employment fell and poverty rose. Foreign capital flows ceased and domestic resource mobilization declined in view of economic uncertainty and contraction. These shocks, and the recent global economic slowdown, have adversely affected prospects for Indonesia and have revealed the structural weakness and policy distortions.

4. To address these structural problems, IMF, the World Bank, and the Asian Development Bank (ADB) have together provided substantial policy and technical assistance (TA) support. ADB's Financial Governance Reforms: Sector Development Program (FGR:SDP),[1] along with IMF and World Bank assistance, has supported a set of public sector reforms that have created the basic legal framework and environment for SOE reforms and their audits, and helped to improve financial governance in both banking and nonbanking sectors. The Jakarta Initiative Task Force (JITF)[2] is facilitating out-of-court debt restructuring agreements, while the Indonesian Debt Restructuring Agency (INDRA) provides exchange rate risk guarantee for repayment of restructured debt. Recovery of nonperforming loans of the banking sector is the responsibility of the Indonesian Bank Restructuring Agency (IBRA).

5. Although Indonesia has made substantial progress in bank restructuring, the corporate restructuring process for both private and state companies has been slow. Further rationalization of economic policies and enhancement of governance structures, competition, and market orientation are critical to ensure sustainable economic growth and efficiency in resource allocation. Recognizing this, in parallel to implementing FGR:SDP (footnote 1), ADB approved the Industrial Competitiveness and Small and Medium Enterprises Development Loan[3] to enhance domestic and external competition and establish equal opportunities for small and medium-size enterprises.

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[1] Loan 1618-INO: *Financial Governance Reforms: Sector Development Program*, for $1.4 billion; Loan 1619-INO: *Financial Governance Reforms Support*, for $47 million; and Loan 1620-INO*: Capacity Building for Financial Governance*, for $50 million, all approved on 25 June 1998.

[2] Established in November 1999 with support from the World Bank.

[3] Loan 1738–INO: *Industrial Competitiveness and Small and Medium Enterprise Development Program*, for $200 million, approved on 16 March 2000.

6. To coordinate corporate governance activities, the Government has set up the National Committee on Corporate Governance (NCCG). NCCG, with assistance from ADB,[4] has developed a framework to improve corporate governance, introduced amendments to the Company Law and other commercial laws as well as measures to streamline company incorporation and registration process, and improve accounting standards and disclosure requirements.

7. To facilitate corporate governance reforms, enterprise restructuring, and privatization, the Government established the Ministry for State-owned Enterprises (MSOE) in March 1998. With the support of ADB,[5] MSOE prepared a masterplan in June 2000 that laid down the objectives and scope for the reform of SOEs. This plan envisaged the eventual privatization of most SOEs, strengthening of their governance, and restructuring where required, while removing privileges and enhancing credibility of the Government as an independent and unbiased regulator and arbitrator. However, MSOE was abolished in August 2000 and its functions transferred to the Ministry of Finance (MOF). While these institutional changes disrupted the privatization of SOEs, the Government continued its efforts to encourage SOEs to adopt the governance framework. The new Government reinstated MSOE in August 2001, and has confirmed its commitment to implement the masterplan in a memorandum of understanding signed on 03 October 2001. The strengthening of corporate governance in SOEs, as supported by the proposed Program, will lead the way for improving governance in the whole corporate sector, as well as in other commercial operations of the public sector. Concurrently, the Government is planning to review legislation and regulatory framework for listed companies with a view to improving enforcement.

8. The ADB Policy Consultation Mission visited Indonesia in September 1998, and discussed with MSOE and other key agencies the issues facing the SOE sector and ADB's potential support for it. In December 1998, ADB approved an advisory TA to address corporate governance and privatization of SOEs (footnote 5). Subsequently, the Reconnaissance Mission was fielded in March-April 1999 to develop an agenda for the Program on the basis of the recommendations of the ADB-financed studies and the SOE masterplan prepared with the World Bank assistance (para. 52). Fact-finding was undertaken in May 1999 to formulate the objectives and scope of the Program and associated TAs and the understandings were firmed up during the Appraisal Mission in May 2000. However, the processing of the loan was delayed between August 2000 and September 2001 because of problems arising from the transfer of MSOE functions to MOF, the political changes stemming from the President's impeachment, and the delays in the resolution of issues surrounding the macroeconomic stabilization program and structural reforms. Following the resolution of these issues, in August 2001, ADB approved a TA for privatizing and restructuring SOEs[6] and a TA for commercializing of public service obligations (PSO),[7] both supporting the Program. Subsequent to the inauguration of the new Government and reestablishment of MSOE, a follow-up mission in September 2001[8] updated the Program in light of emerging developments and firmed up understandings on the Program. The Government's Development Policy Letter and the attached Policy Matrix are given in

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[4] TA 3484-INO: *Corporate Governance Reform*, for $300,000, approved on 28 August 2000.
[5] TA 3149–INO: *Corporate Governance and Enterprise Restructuring*, for $2.47 million, approved on 29 December 1998.
[6] TA 3714-INO: *Privatization and Restructuring of State-Owned Enterprises*, for $2.6 million, approved on 5 September 2001.
[7] TA 3728-INO: *Commercialization of Public Service Obligations*, for $1.0 million, approved on 25 September 2001.
[8] The Mission comprised K-P Kriegsmann, Senior Corporate Governance Specialist/Mission Leader; Michael Ryan, Senior Financial Sector Specialist; C.C. Fong, Senior Counsel; and Thatha Hla, Young Professional.

Appendix 1, and the program framework and its monitoring arrangements are provided in Appendix 2.

III. THE MACROECONOMIC CONTEXT

A. Development Objectives, Strategy, and Plans

9. Since the onset of the economic crisis, successive Governments have implemented macroeconomic stabilization programs and structural reforms to address the short- and medium-term challenges. Significant progress has been made to date in this area. However, lack of public confidence, the global economic slowdown, and the slow pace of structural reforms over the last several months have created new complications including the disruption to the process of economic revival and fiscal consolidation. These problems were created by a weak domestic economy and growing political tensions, due to recurrent civil strife and ethnic tensions, the persistent calls for autonomy by resource rich provinces, and the global slowdown that grew in the first half of 2001.

10. The domestic political crisis culminated in August 2001 with Parliament electing Megawati Sukarnoputri as President. Backed by considerable popular support, the President was swift to appoint a strong and competent cabinet and is striving to maintain a coalition to balance diverse and conflicting interests in Parliament. Also, the Government resumed policy dialogue with the IMF that resulted in signing of an LOI and agreement on the Memorandum of Economic and Financial Policies and paved the way for the release of the pending third tranche of the extended fund facility. The Government expects real GDP to grow in the range of 3.0-3.5 percent in 2001. The macroeconomic stabilization program aims to adhere to curbing monetary expansion and controlling inflation, and has adopted measures to keep the budget deficit to around 4 percent of GDP. These targets are only attainable if the process of asset recovery, corporate restructuring, and privatization of SOEs is accelerated.

11. The recent change in Government offers renewed hope for more sustained economic recovery of the Indonesian economy, but the vulnerabilities persist given the magnitude of economic issues and the difficult political environment. While growing public debt and the need to rein in excess liquidity to curb inflation limit the scope for pursuing expansionary fiscal and monetary policies, the near-term focus will be on accelerating long-delayed SOE reforms, corporate restructuring, and asset sales.

12. During 2000, IBRA intensified its operations and managed net recoveries of $1.8 billion (Rp18.1 trillion) from asset sales. Building on this performance, IBRA plans to raise $2.7 billion (Rp27 trillion) in 2001 ($1.1 billion, or Rp10.5 trillion, had been recovered by 30 June) and $2.2 billion (Rp21.5 trillion) in 2002. MOF and IBRA have agreed on detailed procedures governing asset transactions and sales of IBRA’s restructured loans for sovereign bonds. For the 21 largest obligors, memoranda of understanding have been agreed for debt resolutions and these cases are likely to be legally closed in 2002. IBRA has filed legal action against 50 noncooperating debtors, amounting to $1.3 billion (Rp13.0 trillion) which are expected to be resolved in 2002. IBRA supervision was transferred from MOF to the state minister for SOEs in September 2001 in order to accelerate bank and debt restructuring and to better coordinate the overall asset sales program. Debts not satisfactorily resolved through voluntary mechanisms can be subjected to bankruptcy proceedings. The Government has provided a supportive

regulatory framework[9] for JITF-led restructuring. This has enabled JITF to mediate debt amounting to $12 billion as of the end of June 2001, representing the debt of 54 companies.

13. The Financial Sector Policy Committee (FSPC), an interministerial coordinating committee set up in April 2000, coordinates the activities of JITF, INDRA, IBRA, Bank Indonesia, MSOE, and MOF. IBRA is empowered to take over assets of recalcitrant debtors. The Government can direct cases to JITF, which has been given the power of referral to the attorney general for the initiation of bankruptcy proceedings against debtors that refuse to negotiate in good faith. These improvements to the debt restructuring strategy are expected to create stronger incentives for the debtors and creditors to speed up debt workouts. In April 2001, the FSPC published a set of principles designed to promote economically viable restructuring of distressed companies through a transparent process that aims to maximize recoveries. The principles also constrain IBRA from extending any future guarantees.

14. Major initiatives have been under way to strengthen governance and combat corruption. These have included strengthening of public sector financial management, and the establishment of NCCG to develop a coherent framework for corporate governance for private companies (para. 6). Reforms are under way in public administration to enable effective decentralization. To combat corruption, the Government passed two new laws, on “clean” government,[10] and eradication of criminal acts of corruption.[11] Additionally, a law for the oversight and audit of private foundations has been approved by Parliament in 2001. Effective implementation of these laws and proper role of oversight agencies is critical to implement efficient, transparent, and accountable public administration, and to encourage citizen participation.

15. Within this context, the implementation of a rigorous system of corporate governance for SOEs is critical and is viewed to lead the reforms for the overall corporate sector. Successful corporate restructuring, especially debt restructuring, of SOEs provide models to accelerate related efforts in the private sector. Privatizations through stock exchange listing will promote capital market development. SOE reforms will also establish the best practices in managing labor redundancies.

B. Recent Performance and Prospects

16. Over the past five years, Indonesia has shown remarkable resilience and lived through an unprecedented economic crisis and the associated political and social unrest. Despite these events, the economy showed resilience and real GDP grew to 4.8 percent in 2000 after registering a sharp contraction by 13.2 percent in 1998. The growth prospects for 2001, however, have weakened in light of the continued weak domestic demand, sharp slowdown in exports triggered by global slowdown, political uncertainties, and protracted delays in the corporate restructuring process. Real GDP growth is estimated to be in the range of 3.0 to 3.5 percent in 2001 (para. 10).

17. To maintain macroeconomic stability, the Government in 2001 has kept a close watch on fiscal management. Despite monetary tightening in the first half of the year, monetary expansion rose to 18.5 percent on an annualized basis over the second quarter of 2001. The slippage is

[9] These include the introduction of tax relief for a broad range of restructuring transactions, and regulatory protection at the Jakarta Stock Exchange to prevent delisting for cooperating companies.
[10] The law State Administrators who are Clean and Free from Corruption, Collusion, and Nepotism, defines rights and obligations of state administrators.
[11] The Eradication of Corruption Criminal Act defines corruption and declares it a criminal act to be punished with four to twenty years imprisonment.

largely on account of the downward pressures on the exchange rate, which fell to lows of Rp12,000 to the dollar in April 2001 (compared to Rp7500 in April 2000) at the peak of political uncertainty. Following the impeachment of President Wahid on 23 July 2001, the rupiah appreciated by 30 percent but subsequently fell back to its current level of about Rp10, 500 per US$1. The steep fall in the value of rupiah, Bank Indonesia's failure to control liquidity, and the rise in fuel prices during 2001, created strong inflationary pressures. By July 2001 the 12 month increase in consumer prices reached a two-year high of 14 percent, up from 4.2 percent a year earlier. Higher inflation and political uncertainty resulted in a rise of interest rates. The yield on the one-month central bank certificates (SBIs) stood at 17.6 percent in late August 2001, up from 14.5 percent at the end of 2000.

18. The current account surplus increased from 4 percent of GDP in 1999 to 5 percent in 2000 but is expected to contract significantly during 2001. Weaker external demand and lower natural gas exports will not be fully offset by the projected fall in imports. Maintaining a current account surplus is of vital importance for Indonesia to be able to meet its debt servicing obligations as capital inflows are likely to remain constrained well into and possibly beyond 2002. IMF and World Bank are projected to have negative net lending (repayments are higher than disbursements) amounting to about $1.0 billion in 2001 and 2002. Commercial banks and other private creditors are expected to reduce their exposure by $8.6 billion in 2001 and $6.0 billion in 2002. This leaves a net financing gap of $1.5 billion in 2001 and $2.4 billion in 2002 in the capital account of the balance of payments, which should be met by multi- and bilateral development agencies.

19. The economic slowdown during the first half of 2001 has imposed severe strains on the budget. In line with the IMF program, the Government has scaled its budget deficit target to 3.7 percent of GDP by raising tax revenues by $650 million (Rp6.5 trillion) and reducing subsidies by $930 million (Rp9.3 trillion). Parliament in mid-June passed the new budget. Managing a responsive, yet responsible, fiscal policy is an urgent concern. Among others, it is critical to deal with the issue of the massive buildup of public debt to $127 billion (Rp1,270 trillion). By the end of 2000, this is close to 100 percent of GDP. About half the debt is owed to foreign creditors, including $20 billion to multilateral institutions, $43 billion to bilateral creditors, and $2.4 billion to foreign banks and bondholders. Interest payments alone currently absorb 31 percent of budgetary revenues, curbing the availability of resources to address social development priorities. The Government plans to launch an aggressive sale of IBRA assets and SOEs to mobilize the required resources for debt repayments. Sound macroeconomic policies supported by prudent fiscal management and proper and timely implementation of privatization of SOEs will be critical for meeting these goals. In view of the important role of privatizations for future budgets, the Government has placed a high priority on SOE reform.

IV. THE SECTOR

A. Background and Recent Performance

1. Overview of Corporate Sector and Structure of SOEs

20. The economic vulnerability of Indonesia, as exposed by the crisis, is largely attributable to the inherent structural weaknesses across key sectors of the economy. In the corporate sector, the complex holding company structures with concurrent ownership of banks encouraged the development of a web of nontransparent and highly leveraged conglomerates. These conglomerates indulged in lending to related parties, expanded their operations without due regard for economic or prudential considerations, exploited depositors of their banks, and dispossessed minority shareholders who held stakes in their listed subsidiaries. Excessive

leveraging, without adequate prudential regulatory framework and supervision, overexposed the fragile domestic banking sector. Reckless lending and borrowing were worsened by currency and maturity mismatch in the banks' balance sheets. Following the currency devaluation, a large segment of the corporate sector became insolvent. Corporate losses and the inability and unwillingness to repay debt obligations wiped out the equity of many banks that were overly exposed to commercial and speculative adventures of their majority owners. Although less leveraged and not so severely affected by the crisis as private enterprises, SOEs too suffered from growing operational and financial inefficiencies, and many require restructuring.

21. At a general level, Law No. 9/1969 provides for four main types of SOEs:

(i) perusahaan jawatan (perjan), government departmental agencies established to fulfill PSOs, do not have separate legal existence, their employees are civil servants, and 15 perjan are under MSOE administration;
(ii) perusahaan umum (perum), were established as separate legal entities under a special purpose Government Regulation (Peraturan Pemerintah), their capital is owned by the Government and is not divided into shares, and 13 perum are under MSOE administration;
(iii) perusahaan persero (persero) is a limited liability company established according to Law No. 9/1969 and the Company Law, and at least 51 percent of its shares are owned directly by the Government;[12] and
(iv) other types of SOEs can be established under special laws; an example is the oil company, Pertamina.

22. As of September 2001, MSOE has a portfolio of 155 companies comprising five fully-owned state banks; 12 nonbank financial institutions; 21 companies with the Government as minority shareholder; and 117 fully-owned nonfinancial SOEs, which are the primary target of the proposed Program. Four SOEs are not to be privatized before 2008.[13] A breakdown of the 113 remaining SOEs is given in Table 1, the coverage of SOEs by the different program components is outlined in Appendix 3.

2. Size and Significance of State-Owned Enterprises

23. Traditionally, SOEs have operated in all key sectors of the economy. In 1999, total assets of the 113 SOEs (book value) to be privatized (para. 22) were $39 billion (Rp391 trillion),[14] equivalent to 42 percent of the total assets of Indonesia's producing sector. SOEs employed 655,000 persons on a full-time basis. However, including their subsidiaries and the contract and subcontract workers, the total workforce of SOEs was close to 1.4 million, or 18 percent of the workforce in large and medium enterprises. The contribution of SOEs to the country's GDP was estimated at 12 percent, indicating a relatively low efficiency in the use of labor and assets.

[12] There are 134 perseros under MSOE administration.
[13] The four SOEs are PT Batan Teknologi, producer of isotops for medical radiology; PT Pakarya Industri, holding company for strategic SOEs (proposed for liquidation); PT TWC Borobudur, providing administration services for historic monuments in Yogyakarta; and PT Pindad, an ammunition manufacturer.
[14] $53.2 billion at the 1999 foreign exchange rate (Rp7,350); excluding assets of insurance companies.

Table 1: Breakdown of Nonfinancial SOEs
Financial Year Ended 2000

Sector	Number	Share in Workforce (%)	Share in Assets (%)
Energy	2[a]	8.3	61.7
Infrastructure	10	14.4	13.7
Post	1[a]	4.1	0.5
Telecommunications	2	6.4	9.1
Toll Roads	1[a]	1.0	1.8
Ports	4	1.8	1.6
Airports	2	1.8	1.6
Primary industries	29	55.5	5.1
Plantations	14	51.5	2.8
Fishing	4	0.4	0.1
Forestry	5	1.4	0.5
Mining	4	2.3	1.6
Agricultural Inputs	2	0.1	0.1
Manufacturing	31	9.6	11.7
Construction	10	1.0	1.3
Trade	5	0.8	1.3
Services	26	9.9	5.2
Total	**113**	**100.0**	**100.0**
Addendum:			
SOEs not to be privatized	4		
Banks	5		
Nonbank Financial Institutions	12		
Minority Shareholdings	21		
Total Portfolio	155		

[a] Reforms of these SOEs are dealt with under ongoing World Bank and ADB loans and TAs (para. 57).
Source: Ministry for State-Owned Enterprises.

3. Financial Performance of State-Owned Enterprises

24. In 1999, SOEs[15] accounted for 15 percent of Indonesia's total exports and 19 percent of nonmineral fuel exports in US dollar terms. Benefiting from currency depreciation, SOE exports registered a windfall of $600 million (Rp6 trillion) in 1998, which declined to about $400 million (Rp4 trillion) in 1999 and $250 million (Rp2.5 trillion) in 2000. In 2001 the weak currency is expected to increase the windfall to about $450 million (Rp4.5 trillion). This contributed to enhanced operating profit that rose from $730 million (Rp7.3 trillion) in 1997 to $1.6 billion (Rp15.6 trillion) in 2000. The return on assets in the SOE sector increased from 3.3 percent in 1997 to 6.9 percent in 2000, but still remained below the cost of capital. The rise in profitability doubled the contribution of SOEs to the budget in the form of dividends, from $150 million (Rp1.5 trillion) in 1997 to $350 million (Rp3.5 trillion) in 2000. However, with the slowing domestic economy and the rise in cost of inputs and labor, improved profitability of SOEs is unlikely to be sustained in 2001. The forecast for 2001 in Table 2, on the basis of company budgets submitted to MSOE in January 2001, are probably too optimistic.

[15] The financial data in this section excludes PT PLN because of its extraordinary circumstances and distorting effect on the data.

25. Overall, the financial position of SOEs has remained mediocre in recent years (Table 2). An example has been the rapid growth in losses of the power utility, PT Perusahaan Listrik Negara (PLN), because of its inability to adjust electricity tariffs in line with rising input prices and debt servicing costs.[16] The decline of shareholder value in SOEs, as assessed by the economic value-added (EVA)[17] concept, is estimated at $1.4 billion (Rp13.9 trillion) in 2000, equivalent to 180 percent of social expenditures in 2000. Including PLN, EVA is estimated at negative $3.7 billion (Rp36.7 trillion), equal to 2.8 percent of GDP, or 17.9 percent of government revenue and grants in 2000.

Table 2: Aggregate Financial Data for Selected Industries

Industry	Year	Employees	Assets (Rp'000)	Operating Profit Margin	Return on Assets	Debt Equity Ratio
Plantations						
	1997	293,443	8,368,138	16.9%	8%	0.65
	1998	329,662	11,676,678	42.8%	25%	0.52
	1999	358,659	11,140,381	14.4%	8%	0.57
	2000	337,164	11,000,946	12.9%	6%	0.53
	2001[a]	356,872	12,116,780	19.1%	6%	0.60
Mining						
	1997	16,702	4,054,873	19.6%	6%	0.51
	1998	15,550	5,319,398	42.6%	20%	0.53
	1999	15,039	5,542,065	27.5%	15%	0.49
	2000	14,930	6,431,046	25.2%	14%	0.66
	2001[a]	14,125	6,985,302	24.5%	14%	0.66
Manufacturing						
	1997	82,141	27,983,893	9.9%	3%	1.02
	1998	81,637	35,813,787	10.8%	3%	1.25
	1999	77,669	32,261,897	12.1%	6%	1.19
	2000	76,056	36,693,098	13.8%	6%	0.55
	2001[a]	74,008	40,993,698	13.2%	6%	0.73
Infrastructure exc. PLN						
	1997	96,752	40,685,861	35.5%	7%	0.46
	1998	96,223	48,675,868	37.6%	9%	0.95
	1999	93,852	53,314,163	36.3%	12%	0.78
	2000	95,440	56,493,833	35.4%	10%	0.73
	2001[a]	96,731	62,980,717	36.5%	12%	0.70
Service Industries						
	1997	65,758	11,703,653	1.2%	Negative	2.59
	1998	62,286	16,266,009	-7.9%	Negative	4.70
	1999	60,388	16,179,534	4.4%	8%	3.35
	2000	61,088	18,454,276	9.5%	2%	4.26
	2001[a]	62,602	20,163,654	11.1%	8%	1.26

[a] Forecast.
Source: Ministry for State-Owned Enterprises.

[16] Rises in electricity tariff in 2001 and those scheduled for 2002 reduce the problem but are not high enough to eliminate it.

[17] Economic value added (EVA) is the difference between a company's return on capital and cost of capital multiplied by the amount of capital employed by the company. If EVA is positive, the company creates shareholder value. If EVA is negative, the company destroys shareholder value. In the portfolio of MSOE of 134 SOEs, only seven SOE created shareholder value (positive EVA) in 2000.

26. Despite their poor profitability, proceeds from the sale of SOEs could finance a part of the bank restructuring cost. Based on the 2000 net profit after tax, the market value of all SOEs, excluding banks, is estimated to be in the range of Rp126 trillion (staff estimate) and Rp208 trillion (Government estimate), or $13 billion to $22 billion. This is equivalent to 60 percent and 102 percent, respectively, of the market capitalization of Jakarta Stock Exchange (JSE).

B. Constraints and Issues

1. Corporate Governance

27. Eight SOEs are listed on JSE[18] (including Bank BNI) and subject to capital market regulation. The other 126 SOEs are limited liability companies, subject only to the corporate governance provisions of the Company Law. To adequately monitor their performance and guide corporate restructuring efforts, MSOE, in a first step, needs to raise the governance of these SOEs to the level required for publicly listed companies. However, corporate governance in SOEs involves more complex problems compared to those prevailing in enterprises listed on a stock exchange. The supervisory board and management of SOEs are quite removed from direct accountability to the shareholders. They have no direct responsibility toward the ultimate shareholder, the taxpayer, nor do the taxpayers have any legal means of seeing their interest represented. In May 2000 Indonesia introduced specific rules and regulations for corporate governance in SOEs.[19] Furthermore, external mechanisms of corporate governance enforced through financial markets or banks, have also been largely absent as SOEs enjoyed easy access to credit from state-owned banks and directly from MOF. SOEs have, therefore, tended to mainly serve the interests of the state bureaucracy leading to such excesses as directed allocation of contracts to favored suppliers; use of profits to support nonviable new ventures; and outright corruption, collusion, and nepotism (KKN). To overcome these problems, MSOE needs to implement a system of corporate governance that overcomes the shortcomings outlined on paras. 28-35, and goes beyond the prescriptions of capital market regulations. Thereby it will pioneer the way for the Government's efforts to improve corporate governance for the private sector, to be designed and implemented by NCCG (para. 6). In a first step, NCCG has issued a Code of Good Corporate Governance in April 2001, fully complying with the Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance. However, compliance with the code by companies is voluntary until the code is reflected in the new company law and capital market law, envisaged to be enacted by Parliament in 2002.

28. The Civil Code, the Commercial Code, the Company Law and its regulations provide the legal and regulatory framework for the establishment, operation, and dissolution of companies with limited liability, and the rights, liabilities, and responsibilities of shareholders, managers (directors), and supervisors (commissioners). Securities issuers, and public and listed companies are subject to capital market laws and regulations. The Company Law applies to listed companies, except where capital market regulations prevail. SOEs covered under the Program are limited liability companies governed by the Company Law. SOEs listed at JSE are additionally subject to the rules and regulations of the Capital Market Supervisory Agency (BAPEPAM). Listed companies are additionally subject to the listing rules of JSE.

29. The internal governance of companies as defined in the Company Law provides for a dual board structure for limited liability companies. The board of directors (BOD) is

[18] The six SOEs named in footnote 32 plus PT Indofarma and PT Biofarma, which were listed in 2001.

[19] Ministerial Decree Kep 23 of May 2001, Corporate Governance in SOEs, issued by the Minister for Investment and SOEs.

responsible for the management of a company, while the board of commissioners (BOC) monitors and advises them.[20] The annual general meeting of shareholders has broad authority as it holds powers generally not granted by the Company Law or by the company's articles of association to the BOD or BOC. The Company Law does not, however, stipulate consequences for a company's failure to comply with its provisions. Regulation of the corporate sector is overseen by the Ministry of Justice, Ministry of Industry and Trade, District Courts, commercial courts, BAPEPAM, and JSE (for listed companies). Licensing and regulatory responsibilities for companies that are engaged in commercial activities are with the concerned sector ministries. Bank Indonesia and MOF regulate the banking and insurance sectors, respectively.

30. The BOD of a company must administer, and allow for the inspection by shareholders of, the company's books and records. However, the Company Law does not specify what books and records must be maintained. To be meaningful, the reports should provide audited financial statements,[21] describe the management and operations of the company, and list the names and remuneration of the members of the BOD and BOC, as well as their interest in the company and the company's commercial transactions.

31. Audits of a company's financial statements are not compulsory. Listed companies or companies involved in public fund-raising or those that have issued an acknowledgment of indebtedness, or companies with assets valued at least Rp50 billion (which is the case for 107 of the 117 SOEs) are required to prepare an annual report. Since 1998, these companies are required to provide their annual report to the Minister of Industry and Trade[22] within six months from the end of their financial year along with audited financial statements prepared in accordance with generally accepted accounting principles (GAAP). Compliance to date has been very poor. Public companies and securities issuers are required to submit annual and quarterly reports and financial statements to BAPEPAM with information on their company activities; their BODs and BOCs; use of funds; and investment and share ownership of directors, commissioners, and shareholders. While the reporting requirements are substantial, compliance has been weak, and largely depending on the integrity of management.

32. The Indonesian generally accepted accounting standards (GAAP) are determined by the Financial Accounting Standards Board (Dewan Standar Akuntansi Keunangan, or DSAK), which is part of the Indonesian Institute of Accountants (IIA). Together with the regulations for listed companies stipulated by BAPEPAM, they define financial accounting standards. In 1994, DSAK made the strategic decision to harmonize the Indonesian Financial Accounting Standards with the International Accounting Standards (IAS). The DSAK has issued 55 accounting standards, 35 in 1994 and 20 over the last six years, which are consistent with the recommendations of the International Accounting Standards Committee. Although IAS are not commonly adopted by Indonesian companies, in most cases there is little difference between IAS and Indonesian GAAP.

[20] Indonesian law is based on Dutch law and prescribes a two-board structure consisting of supervisory board and an executive board. Under the Indonesian law, the commissioners are the equivalent of nonexecutive directors in European companies and form the BOC, vested with all supervisory functions, while the Directors are the equivalent of executive Directors in European companies and form the BOD, which is responsible for managing all company affairs. By contrast, under the Anglo-Saxon law system, companies with limited liability have one BOD consisting of executive Directors and non-executive Directors.

[21] Including a balance sheet, a profit and loss statement, a cash flow statement, a statement of debt and receivables (including bank credits), a list of shareholders, and explanatory notes.

[22] Decree of the Minister of Industry and Trade No. 525/Kep/XI/1998 of 13 November 1998 on Administration and Registration of Annual Financial Reports of Companies. Currently, the Minister of Industry and Trade has delegated the relevant authority to the Company Registration Office in the Department of Industry and Trade.

33. Overall, Indonesia's corporate and commercial system is not working under a robust system of corporate governance. Existing rules and regulations have not been rigorously enforced, in private companies or SOEs. External mechanisms and enforcement through banks and capital markets, which are a feature of corporate discipline in other countries, have not functioned well in Indonesia. There has been little incentive for internal mechanisms or voluntary best practices to be introduced. As a result, the following mechanisms common in other countries are either unavailable or only nominally available:

(i) comprehensive disclosure in corporate reporting, independent directors or commissioners safeguarding the rights of minority shareholders, and transparency in financial dealings with related parties;
(ii) sound legal system, with a good record of enforcement by an impartial judiciary (breaches in corporate governance, even if detected, were not pursued for judicial resolution); and
(iii) external discipline exercised by the financial sector (for a complex web of well-connected individuals and conglomerates, capital was readily available before the crisis).

34. Apart from enforcement of general standards, corporate governance should establish proper ownership and control structures for SOEs that align risk borne by owners with management control to improve their financial and operational performance. A fundamental problem in SOEs is that those who bear the risk of losses—the public—can neither control operations nor escape losses. For the internal governance of corporatized SOEs to be effective, the Government needs to enforce rigorous accountability and transparency, and provide autonomy and adequate incentives to supervisors, managers, and employees to meet commercial objectives.

35. Contractual arrangements between the shareholder, BOC and BOD, where they exist, are not uniform or transparent, and do not establish clear accountability. Consequently, it is difficult to assess the performance of BOCs and BODs whose appointments in most cases are not based on merit. As a consequence of the lack of systematic contractual arrangements and adequate management information systems, MSOE has only rudimentary knowledge of the SOEs in its portfolio. Internal organizational and capacity constraints have limited responsible Government agencies' ability to develop information-processing capabilities. The SOEs generally disregard their legal obligation to file audited financial statements with the Company Register. Since MOF represents the Government as the sole shareholder in 134 SOEs, it should have regular and unlimited access to the relevant financial, operational, and strategic information of SOEs.

2. Public Service Obligations

36. The Government has in many cases used SOEs to provide public goods and services to the population. These range from transportation services in remote areas to vocational education and health care services. Political interference in the pricing of such services and inadequate accountability in SOEs have resulted in inefficient delivery mechanisms. The services are either cross-subsidized by profitable business units in the SOE or subsidized by the Government. This practice diverts resources from profitable activities, lowers overall returns, and impairs the growth potential of SOEs, while eliminating incentives for efficiency in the provision of PSOs. Currently a large segment of SOEs are entrusted with PSOs, such as obligations to provide for reforestation services in Sumatra and Kalimantan, supply vaccines at below cost prices to the public health system, maintain unprofitable air and shipping services, and operate remote air and sea ports. PSOs should be contracted out separately and

transparently to ensure full cost recovery by their provider. The Government has corrected some tariff and other fiscal distortions as part of its structural adjustment program, but subsidies, cross-subsidies within SOEs, and directed price fixing continue. To increase transparency and achieve full management accountability for commercial success, the Government needs to separate PSOs from commercial activities in SOEs in preparation for their eventual privatization. Without such separation, SOEs cannot achieve a return on capital sufficient to attract private investors.

3. Corporate Restructuring

37. Corporate restructuring includes financial (debt) and operational restructuring. To date, 10 SOEs have reached debt-restructuring agreements with their creditors, 8 have ongoing negotiations, and 1 has been sued for bankruptcy.[23] The financial restructuring of SOEs (except banks) has proceeded slowly as (i) the Government is not pressing for debt restructuring as it may add to the already high fiscal costs incurred in bank restructuring, and (ii) creditors (in the majority state-owned banks) are reluctant to pursue SOEs with the same vigor as private sector debtors. Financial restructuring is needed in at least 40 SOEs with unsustainably high levels of debt, 16 of which have IBRA as the main counterpart in their debt restructuring negotiations. The other 24 SOEs have state-owned banks and MOF as their main creditors. Another 17 SOEs have debts that are with IBRA and are expected to be resolved on commercial terms.

38. Operational restructuring is needed in at least 87 SOEs given their poor operational performance even before the crisis. Operational restructuring requires adequate (i) management information systems, (ii) production and logistics planning, (iii) distribution network, (iv) marketing strategy, (v) workforce number and composition, (vi) organizational structure, and (vii) separation of PSOs from commercial operations. SOEs have about 10-20 percent[24] excess labor, inflexible production processes, inadequate strategic planning, unreliable distribution networks, and no long-term marketing strategy. An approach to SOE corporate restructuring is to involve the private sector at an early stage, but the widespread insolvency has complicated this option as few domestic banks or corporations have resources to lend to or invest in the SOE sector. Even fewer have the managerial capacity to acquire nonperforming state assets and to turn them around. The alternative is to restructure viable SOEs with the objective of eventual privatization involving overseas portfolio and strategic investors. However, where restructuring involves the injection of fresh capital, it has to be left to future private owners.

39. The Government is committed to support financial and operational restructuring of SOEs and their privatization without, however, supporting new investments for merger, modernization, or expansion of existing production facilities.[25] Corporate restructuring of SOEs will complement and reinforce the tasks of (i) JITF which is facilitating the voluntary resolution of corporate debt; (ii) IBRA, charged with resolving or liquidating non-performing loans in its portfolio; and (iii) INDRA, which facilitates the conversion of foreign currency-denominated debt into rupiah at guaranteed exchange rates. Together, these initiatives are to assist almost 2,000 private and public sector enterprises. Consistent with these initiatives, the Government identified for financial restructuring 60 SOEs, 40 of which require urgent action (para. 42). Furthermore, MOF will not provide financial restructuring support to any SOEs that can self-finance their restructuring program, or will not be privatized, or require regulatory reform prior to restructuring

[23] The Vietnam Frontier Fund filed a bankruptcy suit in May 1999 against PT Dok and Perkapalan Kodja for its failure to pay $100 million in promissory notes.
[24] Based on some recent estimates, the actual level of overstaffing may be closer to 10 percent.
[25] The Government has demonstrated this commitment in the case of PT Indo Farma and PT Kimia Farma, where the proceeds from the IPO went to the companies to be used for corporate restructuring.

and privatization. These SOEs will, however, receive support under the proposed Program for complying with regulatory reforms, improving corporate governance, applying anticorruption measures, and offering voluntary retirement schemes.

40. The Government plans to reform SOEs with long-term viability whose value to a potential investor would be enhanced by financial and operational restructuring, and to consider for immediate sale or liquidation those that have no commercial viability and lack any value as going concerns. Preliminary analysis indicates that at least 14 SOEs lack commercial and financial viability.

41. Financial restructuring will take place within a well-defined legal framework, enforced through newly established institutional arrangements. Commercial courts, which constitute a part of the general court system, have the mandate of hearing bankruptcy and commercial cases relating to arbitration, competition, and security issues. These courts are entrusted with the application and enforcement of the Bankruptcy Law to facilitate and encourage corporate debt restructuring. The Bankruptcy Law, amended substantially in 1998, aims at (i) improving the speed and transparency of cases; (ii) drawing receivers and administrators from the private sector; (iii) protecting debtor's assets (against insider and fraudulent transactions); (iv) facilitating the foreclosure on collateral by secured creditors; and (v) accelerating out-of-court settlements with the consent of at least 50 percent of unsecured creditors, representing no less than two-thirds of outstanding claims. Debtors and creditors failing to reach out-of-court workout settlements under JITF, or to get the requisite creditor support for the workout plan, can resort to the commercial court to bind hold-out creditors,[26] impose strict guidelines on the negotiating process, or achieve liquidation of the company. However, public confidence in the commercial courts is still low, since they do not function efficiently or address problems of financially distressed companies. As such, they do not yet provide adequate support for corporate restructuring being pursued under JITF.

4. Labor Redundancies

42. As mentioned in para. 38, SOEs need to reduce employment by 10 to 20 percent. Support for SOEs to finance labor retrenchment and training will improve their prospects for successful restructuring and privatization. Such retrenchment will be guided by Indonesia's labor laws, which are of high standard. In 1998, Indonesia signed an LOI with the International Labour Organization (ILO) for the ratification of ILO's seven core conventions. These include freedom of association, and freedom from forced labor, discrimination, and child labor. As of January 2000, Indonesia is the only country in Asia to have ratified all the seven core conventions. A tripartite task force consisting of unions, the Government, and employers has been established and is working with ILO in the implementation of labor standards.[27] The ratification of ILO Convention 87 regarding the right of association has enabled SOE employees to join a union or engage in collective labor arrangements, though procedures for resolution of labor disputes still have to be clarified. During the past 24 months, 102 labor unions have registered or are in the process of registering with Ministry of Manpower (MOM). If no union exists, an association with an elected spokesperson can represent employees to management.

43. The threat of unemployment because of liquidation, privatization, and restructuring of SOEs is a matter of concern to all employees due to uncertainties about settlement of their severance claims and the prospect of privatization in general. Since 1997, 10 SOEs have

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[26] The court can force creditors delaying a restructuring agreement to accept it if a qualified majority of creditors agree on it.

[27] Three draft laws are currently waiting for processing by Parliament: (i) trade unions law, (ii) dispute settlement law, and (iii) manpower development law.

downsized through voluntary settlement of employment termination. Among these, Indonesia Aerospace Industries (IPTN) laid off 3,780 workers and Garuda Indonesia laid off 1,600. The labor rationalization took place in consultation with employees through elected representatives rather than union leaders, and the process was completed with minimal labor disruption. Employees were offered severance payments 25-40 percent higher than prescribed in the Presidential Decree No. 3 of 1996. Under the regulation, employees are entitled to mandatory compensation[28] including severance pay, service benefit, and other compensation on the following scale:

Table 3: Mandatory Severance Compensation

Severance Pay	Months Pay	Service Benefit	Months Pay
Less than 1 year	1	5-10 years	2
1-2 years	2	10-15 years	3
2-3 years	3	15-20 years	4
3-4 years	4	20-25 years	5
More than 4 years	5	more than 25 years	6

In the cases of (i) company closure and (ii) change of ownership with employees refusing to continue working, the following mandatory compensation applies: severance pay plus service benefit plus other compensation. In the cases of (iii) mass termination caused by efficiency measures and other non-worker related reasons, and (iv) change of ownership with the company unwilling to reemploy the employees, the following compensation is mandatory, two times severance pay plus service benefit plus other compensation. The generous settlements being offered have been welcomed by employees and their representatives, a large number of them continue to be concerned about their employment prospects under the reform program. The anxiety about employment prospects is particularly strong among contract laborers, who do not enjoy the same protection as regular workers. While there are examples of amicable resolution of labor retrenchment issues, there is no certainty about the application of these practices in future cases, or these practices are not generally known. This is to be dealt with by MSOE through strengthening public relations and establishment of a consultative process to improve information dissemination.

5. Corruption, Collusion, and Nepotism (KKN)

44. KKN is attributable to lack of transparency, availability of privileges linked to connections, and inadequate action against malpractices. In December 1998, the Government disclosed that financial losses arising from KKN across ministries during the past 32 years had exceeded Rp2.9 trillion ($0.4-1.0 billion, depending on the exchange rate used). In July 1999, the Government disclosed an additional Rp7.2 trillion of financial losses due to KKN in ministries and SOEs. After investigation, the Government in 1999 ordered the cancellation of 79 projects, rebidding of 25 projects, reauditing of 59 projects, and renegotiation of 10 projects. In view of rising public pressure, the Government has carried out special audits for Pertamina, Bulog, PLN, and the Reforestation Fund, and made their main findings public. KKN in SOEs is concentrated in procurement. This area was a key focus in the last round of special enterprise audits conducted by international auditors and completed in June 2000 but not yet published. Selected enterprises include the national airline, the national toll road operator, the domestic telecommunications company, public port corporations, and major plantation companies.

[28] The category other compensation includes compensation includes compensation for remaining annual leave and long service leave, compensation for repatriation, compensation for medical insurance, and compensation for housing facilities. They are determined on a base by case basis.

45. At a more general level of governance, Government's efforts to reduce corruption involve (i) improving access to markets, (ii) legal reform, and (iii) strengthening public administration. ADB has assisted the Government in developing its governance and anticorruption strategy.[29] A high-level policy seminar was held in Jakarta in July 1999 under ADB sponsorship to raise stakeholder awareness on this issue. An anticorruption law was enacted in April 1999 providing disclosure standards for public employees and mandating the establishment of an independent anticorruption body within two years. An additional antibribery law was passed by Parliament in July 1999 mandating criminal sanctions for corruption. Since early 2000 ADB has been cooperating with the United Nations Development Programme (UNDP), World Bank, and the Government in a "Partnership for Governance," which puts a strong emphasis on supporting the Government's fight against corruption.

C. Government Expenditure

46. During the 1990s, SOEs were unable to generate sufficient profit to finance expansion. Consequently, they ended up borrowing excessively or establishing joint ventures. Many SOEs became high-cost producers of products and services as they, under political pressure, participated in nonviable ventures or served the Government's social and employment goals. For example, many SOEs were forced to take shareholding in toll road projects designed by the national toll road operator, PT Jasa Marga. Similarly, many SOEs ended up with shareholding in the national aircraft manufacturer PT IPTN, and were forced to carry the burden of successive capital restructurings. SOE performance was affected by lack of clarity about objectives, weak incentive structures, and soft budget constraints that enabled financing of their losses and capital outlay. While quantification of the level of transfers and subsidies from the Government budget is difficult, a World Bank study[30] for 22 SOEs suggests that equity contributions and loan forgiveness amounted to $1.5 billion (Rp3.0 trillion), and price support to $1.8 billion (Rp3.5 trillion), compared to dividends of $420 million (Rp854 billion) in 1996. Given ineffective governance mechanisms, SOEs largely operated without proper accountability and transparency as well as financial discipline. Accounting practices did not allow reliable monitoring of management and enterprise performance, and encouraged widespread irregularities, making it difficult to assess the value for the shareholder.

47. SOEs will continue to burden the budget through the exchange rate risks associated with the two-step offshore foreign currency loans raised by them during the 1990s. The SOEs repay these obligations, including the interest payments, to the Government in local currency at the exchange rates prevailing on the drawdown dates. There are no consolidated records of the size and composition of such two-steps foreign currency loans, which are administered by MOF. ADB provided a TA to MOF to assess its loan portfolio and establish a unit for its risk management.[31] Liabilities of exchange risk coverage on these two-step foreign currency loans are huge. Preliminary estimates are about $20 billion. As an example, future obligations of PT Telkom's two-step loans amount to Rp27 trillion, or close to $3 billion at the current exchange rate. If PT Telkom had borne the exchange rate risk since 1998, over half of its shareholders' funds and its entire profit would have been wiped out.

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[29] TA 3381-INO: *Establishment of an Anticorruption Commission*, for $1,000,000, approved on 28 December 1999. TA 3474-INO: *A Governance Audit of the Public Prosecution Service*, for $1,000,000, approved on 21 July 2000.

[30] World Bank, 1998. Indonesia Public Expenditure Review-Budget, Off-Budget Items, and SOEs. Washington. The study used 1996 exchange rates.

[31] TA 3241–INO: *Improving the Management of Government Onlending Operations*, for $400,000, approved on 1 July 1999.

D. Government Objectives and Strategy

48. Despite the significant fiscal costs of operating SOEs in various sectors, the Government made only limited attempts to reform and privatized SOEs in the 1990s. The first phase of privatization implemented between October 1994 and December 1996 preceded the economic crisis. It involved the sale of minority stakes, ranging from 10 percent to 35 percent, in six of Indonesia's largest SOEs on domestic and international capital markets.[32] The divestment raised close to $4.3 billion. MOF held the nominal ownership of SOEs and, in principle, was supposed to exercise its control rights by setting up specific performance targets for SOE operations and issuing guidelines for dividends. In practice, the power of SOE management, administration, and supervision rested with the sector ministries. This institutional arrangement in effect confounded the actual property rights over SOEs between MOF and the sector ministries. The sector ministries frequently interfered in the commercial operations of SOEs and exerted considerable power of informal property rights due to personal allegiance, subsidization, and outright corruption, cronyism, and nepotism.

49. The second phase of SOE reforms, induced by the crisis, started in early 1998 when the Government changed the institutional arrangement for the oversight of SOEs. As a first step, Presidential Decree Nos. 12 and 13 of 1998 transferred the power of SOE management, administration, and supervision from the sector ministries back to MOF. SOEs were delinked from the purview of sector ministries to remove the latter's interference in SOEs' commercial operations and refocus sector ministries to their primary function of sector policy making and regulation. In the third phase, in May 1998, Presidential Decrees Nos. 50 and 64 were issued to transfer the management responsibility of SOEs from MOF to the newly established MSOE, with a view to providing them with increased managerial autonomy. In December 1999, 4 state-owned banks and 14 financial institutions were transferred from MSOE back to the MOF. To improve Cabinet efficiency, MSOE was dissolved on 26 August 2000, and oversight over the SOEs was transferred to a directorate general for SOEs (DG BUMN) in MOF.[33] On 10 August 2001, MSOE was reinstated by President Megawati Sukarnoputri as a state ministry.

50. These changes have streamlined institutional arrangements for SOEs. MOF continues to oversee the financial aspects of SOEs, including share custody, financial audits, and receipt of dividends and revenues from the sale of shares. All other property rights are now exercised by MSOE: (i) dividend payments; (ii) appointment and termination of contracts of SOE commissioners and directors; (iii) merger, consolidation, sale, and liquidation of SOEs; and (iv) granting of Government guarantees for SOE debt. However, the process of SOE restructuring and privatization will continue to require close interdepartmental coordination between MSOE and the sector ministries, particularly in PSO-related matters. The Government has therefore established the minister-level Privatization Consultative Committee to coordinate the reform process.

E. External Assistance to the Sector

51. Since the onset of the economic crisis, donors have coordinated closely in Indonesia to oversee the implementation of the macroeconomic stabilization program and structural reforms across critical sectors. Responding to the crisis, ADB approved the FGR:SDP (footnote 1) to help strengthen financial sector policies and regulatory framework, restructure and recapitalize banks, and initiate a number of reforms of SOEs. In early 1999, ADB approved a program loan

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[32] PT Telkom, PT Indosat, PT Semen Gresik, PT Tambang Timah, PT Amka Tambang, and PT Bank Negara Indonesia.

[33] Refer to Presidential Decree No. 89 of 10 October 2000.

for the power sector[34] to help split up a major SOE, PLN, and privatize commercially viable components. The program supports the Government's reform agenda and involves dismantling the vertical monopoly in the power sector to increase private sector participation and to move toward competitive markets for generation and distribution of electricity, with a single company responsible for national transmission.

52. With the financial and power sector restructuring under way, ADB has been coordinating with other funding agencies, including IMF, to support revival of the real sector. The World Bank financed the preparation of a first SOE masterplan in 1999 and provided a loan[35] that has supported restructuring and partial privatization of a first group of 12 of the largest SOEs. While including selective policy measures for the SOE sector, the World Bank loan was primarily a broad-based structural adjustment operation that covered improvements in macroeconomic management, legal and regulatory framework for bank and corporate restructuring, governance, transparency, efficiency, and social safety net for the poor across several sectors. Apart from this World Bank contribution, ADB is the only institution to provide support for structural adjustments in the difficult SOE sector.

53. ADB approved a TA in December 1998 (footnote 5) to develop governance structures for SOEs, implement a strategic planning system in MSOE, design privatization and restructuring procedures, assess the legal framework for privatization, and prepare corporate restructuring and privatization plans for a group of 40 SOEs. As a lead funding agency in corporate governance, apart from helping formulate overall structural reforms to introduce higher standards of corporate governance among SOEs, ADB has been supporting specific efforts in the power sector (para. 51), gas transmission industry, insurance, and pension funds. Meanwhile, the World Bank has been helping to open the telecommunications industry to the private sector and improve efficiency in the postal monopoly.

54. During processing,[36] ADB has closely coordinated with the IMF, whose LOI of 27 August 2001 reconfirms the major elements of the proposed Program and includes provisions for monitoring the progress in privatizing SOEs by setting targets for proceeds from their sale. ADB also has an ongoing dialogue with Japanese authorities and has kept them informed about the progress of the Program.

F. ADB's Operations and Strategy in Indonesia

1. Country Strategy

55. ADB's new country operational strategy (2001-2004) for Indonesia, which was finalized in early 2001, focuses principally on reducing poverty and regional inequity, and is anchored in good governance as the strategy recognizes its crucial importance in the Indonesian context. The strategy has four principal areas of operational focus where assistance will have to be

[34] Loan 1673-INO: *Power Sector Restructuring Program*, for $380 million, approved on 23 March 1999; and Loan 1674-INO: *Capacity Building for Establishment of a Competitive Electricity Market*, for $20 million, approved on 23 March 1999.

[35] Policy Reform Support Program for $500 million, approved in May 1999.

[36] Processing of the proposed Program was suspended between August and December 1999, along similar action of IMF and the World Bank, due to the Bank Bali scandal and political uncertainty during the transition to a democratically elected government. All three institutions resumed operations in late 1999. IMF agreed on a new LOI in January 2000, covering a new three-year extended arrangement until December 2002. The previous extended arrangement from late 1997 was terminated. Only $10 billion out of $12 billion was used. The new arrangement is for almost $5 billion, an enhancement of around $3 billion over the pervious arrangement. Processing of the proposed Program was again suspended between May 2000 and September 2001 due to political uncertainty.

programmed: encouraging sustainable recovery and pro-poor growth, improving regional equity through balanced regional development, enhancing human and social development, and mainstreaming environmental management to ensure sustainable use of natural resources.

56. In view of the governance-related issues in the financial and corporate sectors that had contributed to the financial crisis, support for improving financial and corporate governance in order to build up a more stable and resilient financial and corporate structure is a major element of the governance strategy for Indonesia. In the area of corporate governance, reform of the SOEs, which contribute a significant share to the overall GDP, is critical. The crisis had exposed serious weaknesses in the functioning of SOEs, much of it governance related; thus, improving their functioning and privatizing them is a priority.

57. The poor performance of SOEs is also a major factor contributing to the fiscal weakness of the public sector and impeding economic recovery in general. Improving their performance and assisting their privatization is thus also consistent with the focus in the country operational strategy on encouraging sustainable recovery. The program of SOE privatization is also a key element of the Government's structural adjustment program supported by IMF's current $5 billion three year extended fund facility. On 27 August 2001, the new Government signed an LOI with IMF that allowed a release of a $400 million tranche from the Facility. This tranche had been delayed since December 2000 owing to lack of progress on reforms and its release signals that the IMF reform program is back on track.

2. Sector Strategy

58. ADB's operational strategy for SOEs supports fostering competition and establishing a transparent and predictable policy regime across the trade, industry, and financial sectors. Overleveraging and exposure to unhedged foreign currency liabilities have resulted in a severe financial crisis. With extensive support from external funding agencies, including ADB, the Government has moved to strengthen financial sector governance standards, restructure the sector, and improve its viability through consolidation and recapitalization. In addition, ADB is helping, with a recent program (footnote 3), to streamline and rationalize the industrial policy and regulatory framework so that both public and private enterprises, particularly small- and medium-sized enterprises, develop in an open and competitive environment to support higher and sustainable economic growth.

59. While industrial deregulation and liberalization is in progress, the SOE sector, which is an important segment of the economy, needs a program focused at comprehensive corporate restructuring. ADB assistance in the first phase has involved targeting SOE reforms as a part of the FGR:SDP. This program has focused on (i) enactment of anticorruption legislation; (ii) study of private provision of public services, their pricing, costs, and benefits; (iii) performance audit by the Finance and Development Supervisory Board (BPKP) of selected SOEs and special state agencies, and capacity-building programs to raise the quality of public sector auditors and inspector generals of ministries; and (iv) issuance of regulations requiring increased disclosure in audited financial statements of SOEs and a decree on the mandatory publication of SOE audit reports. Progress has been made in all these areas, but delays have been experienced in some policy actions because of changes in institutional arrangements.

60. In December 1998, ADB sponsored a substantial study on corporate governance in Indonesia (footnote 5). The study revealed major weaknesses of the precrisis corporate governance regime and highlighted improvements achieved in 1998. While the legislative framework for corporate governance is mostly in place, compliance and enforcement are the major concerns. ADB's strategy is to support strengthening of corporate governance in key

segments of the economy. Just as the FGR:SDP has improved governance in the financial sector, the proposed Program will establish improved governance practices in the SOE sector by enforcing rules and regulations and addressing special agency problems through contractual arrangements. In the process, the policy, regulatory, and institutional framework for improving governance standards in private companies will also be strengthened by transferring experience gained under the Program. ADB, along with other agencies, is supporting NCCG (footnote 4) to better define its role and functions and to help encourage development of structures and mechanism to improve corporate governance in the private sector.

V. THE PROGRAM

A. Rationale

61. Though established to serve both economic and social goals, SOEs have been an inefficient supplier of both public and private services and goods. The provision of social services and contribution to regional development objectives have largely been achieved at a considerable cost to society. Inefficiencies arose because of indiscriminate subsidization and protection of SOEs without due regard for economic viability and competitiveness. Moreover, SOEs have been exploited for the benefit of individuals and associated interests, accompanied by growing corruption and collusion or outright fraud. This neglect of governance in the Government's sphere of direct influence has encouraged lax governance in the private sector, to the detriment of creditors and minority shareholders.

62. SOE performance in Indonesia has been affected by:

- (i) weak corporate governance such as Government interference, poor internal controls, loopholes in accounting practices, and weak auditing standards and practices;
- (ii) lax supervision and insufficient accountability that have distorted performance incentives for supervisors and staff;
- (iii) weak enforcement of commercial laws and regulations;
- (iv) ill-conceived market protection and administered price controls; and
- (v) ineffective SOE management.

63. The SOE reliance on two-step foreign currency loans that they received in local currency has significant long-term budgetary implications (see para. 47). Under the standard onlending arrangements, the Government carries the full exchange rate risk on both interest and principal for SOEs' borrowings. Preliminary estimates suggest that in the next 10 years these costs will amount to over $20 billion, possibly higher than the total sale value of SOEs. The persistent subsidization of SOEs' products and services, their excessive reliance on government funding, and their wasteful spending because of lack of accountability have added to the financial burden of SOEs. Furthermore, SOEs' inefficiencies have held back growth of quality service. For example, PT Telkom is unable to expand its infrastructure to cater for increasing demand. Given its restricted access to equity, it cannot pursue investment opportunities, even if substantially leveraged. PT Telkom's investment in a number of leveraged joint ventures has constrained its further growth. Similarly, PT Jasa Marga launched a number of leveraged joint venture build-own-transfer toll road projects that are now in serious financial difficulty.

64. Overall, the costs of holding on to the portfolio of SOEs are significant: (i) the opportunity cost of capital invested in SOEs (see footnote 17) amounted to $3.7 billion (Rp37 trillion) in 2000 (Rp23 trillion is attributable to the national electric company PT PLN alone). These will decline to about $2.5 billion (Rp25 trillion) in 2002, and are expected to remain at that level in

the foreseeable future; (ii) the past practice of exchange rate risk being borne by the Government under two-step loans will burden the state budget with at least $1.1 billion (Rp11 trillion) per year during the next decade; and (iii) the direct costs of delayed interest payments for loans from MOF to individual SOEs is estimated to amount to $300 million (Rp3 trillion) annually. The aggregate cost of (i), (ii), and (iii) is $3.9 billion (Rp39 trillion), equivalent to four times the expenditure for housing and human settlement, five times the expenditure for education, and eight times the health expenditure. It does not yet include future debt-to-equity swaps, loan foregiveness in the context of IBRA debt restructurings, and losses from SOE liquidations, which may occur in any year.

65. Despite protection, subsidies, and guaranteed access to foreign lending, investments in SOEs have yielded poor returns. The rupiah depreciation did improve the financial position of SOEs only marginally due to increases in debt servicing costs, a drop in domestic demand, increases in the cost of imported raw materials, and tightening of credit availability. The economic crisis also severely affected the profitability of most SOEs and wiped out their equity. While subsidization of SOEs has been scaled down due to fiscal pressures, many SOEs have raised additional debt or stopped servicing their debt obligations to cover operational losses and meet day-to-day obligations. This avoids tough decisions in the near-term, but raises the long-term cost of SOE reform considerably and complicates the process of debt resolution, which is critical to maintain momentum of the banking sector reforms.

66. The growing distress of SOEs and the need to address fundamental structural distortions of the economy exposed during the economic crisis have brought to the forefront the urgency of SOE reforms. The Program focuses on strengthening SOE governance with the objective of their restructuring and eventual privatization. The Government has started to enforce higher corporate governance standards in the commercial enterprises under its direct control, while reforming the legal, regulatory, and institutional framework for inducing greater competition and market orientation across sectors. This holistic approach to corporate governance will also help introduce and enforce best corporate governance practices in the private economy and provide the incentives for sound investments. It will also improve prospects for the privatization of profitable SOEs and support restructuring of ailing SOEs, thereby reducing the financial risk in the Government's SOE portfolio. Sole emphasis on corporate restructuring or privatization of SOEs without improvements in corporate governance is not feasible, as the restructured or privatized enterprises are not likely to reach sustainable profitability or attract domestic and foreign investors. Improved profitability in the state sector and corporate restructuring of SOEs will reinforce the ongoing bank sector restructuring.

67. Recognizing this, the Government has adopted privatization of SOEs as a key strategy to enhance economic liberalization and generate revenues for debt repayments and bank recapitalization. However, poor planning, weak public relations, and opposition from vested political and bureaucratic interests have delayed the privatization process. MSOE, established in 1998, took some time to develop its own capacity and a final and comprehensive masterplan for the SOE reforms was only announced in June 2000. To support this masterplan, the Program aims to introduce corporate governance mechanisms that align management incentives with shareholder objectives and interests, separate PSOs from commercial operations of SOEs, and enforce SOEs' compliance with legal and regulatory obligations. These measures will facilitate financial and operational restructuring of viable SOEs and liquidation of nonviable ones, while generating momentum for privatization of commercially successful enterprises. To support this process, the Program also calls for adopting a human resource development policy guaranteeing fair treatment of redundant employees, thereby accelerating labor restructuring and eliminating or reducing opportunities for KKN, particularly in the procurement process.

B. Objectives and Scope

68. The proposed Program will improve resource allocation in the public sector, increase profitability of Indonesia's SOEs, and promote private sector participation in the commercial activities of SOEs. Reform of SOEs, involving transfer of ownership and management, and confining the Government's role to policymaking and regulation, will release scarce resources for poverty reduction and social programs. This will be achieved by

(i) subjecting SOEs to sound corporate governance practices;
(ii) separating commercial activities of SOEs from their PSOs;
(iii) restructuring and privatizing SOEs;
(iv) establishing fair and transparent procedures for managing labor redundancies; and
(v) strengthening and effectively enforcing guidelines for procurement in SOEs.

69. The proposed Program will concentrate on restructuring of SOEs incorporated as companies with limited liability (perseros) under the authority of MSOE. It excludes banks and financial institutions that are being restructured under the FGR:SDP and other programs, and utilities such as the electricity supplier (PT PLN), natural gas transmitter (PT PGN), postal monopoly (PT Pos), and toll road operator (PT Jasa Marga) that are supported under separate ADB or World Bank loans and TAs.

70. The proposed Program will be implemented over the next three years, targeting reforms in selected subsets of the SOE portfolio held by MSOE (for details, see Appendix 3) by

(i) introducing the new corporate governance standards and practices in 88 SOEs that are not to be privatized in the next 3 years,
(ii) commercializing PSOs in selected SOEs where such obligations have been identified,
(iii) restructuring the finances and operations of 30 SOEs that are suitable candidates for rapid improvement and subsequent divestment,
(iv) privatizing 15 SOEs where access to equity capital and/or management expertise will improve prospects for profitability,
(v) selling the minority shareholding in 12 companies,
(vi) liquidating 8 unviable SOEs,
(vii) applying the labor retrenchment policy to all SOEs, and
(viii) auditing procurement and procurement practices in 40 randomly selected SOEs.

C. Policy Framework and Actions

71. The policy framework and actions that have been agreed with the Government are described in detail in the development policy letter and the attached policy matrix (Appendix 1). The major actions are outlined here.

1. Corporate Governance

72. The introduction of sound corporate governance standards and practices involves setting in place a set of structures, procedures, and incentives, that empower managers to create shareholder value under adequate supervision, in a transparent environment, and with adequate accountability. This includes contractual arrangements to improve accountability and transparency, as well as enforcement of commercial laws, standards, and regulations. Accountability will be established through standardized and formalized contractual

arrangements, which involve the Government agreeing on statements of corporate intent (SCIs) and entering into appointment agreements with commissioners and directors of SOEs. For SOEs listed on JSE, the Program prescribes the rigorous application of JSE listing rules (para. 77) thereby giving priority to the protection of minority shareholders.

73. The Program calls for the implementation of SCIs for at least 88 SOEs. Going beyond the financial and corporate information required in the annual report of a listed company, the SCI provides specific and strategic directions to the BOD. The SCI defines the (i) objectives and scope of SOE activities; (ii) business and corporate restructuring plan and an assessment of cost and savings; (iii) accounting policies; (iv) performance targets in relation to prescribed objectives; (v) information requirements of the shareholding ministry; (vi) compliance with environmental legislation to be confirmed through certification by accredited agency (e.g., ISO 14000); (vii) employment status of staff and compliance with laws and regulations regarding labor relations; (viii) procedures to be followed for acquisition or sale of shares and divestment of subsidiaries; (ix) compensation for SOE activities from the public sector, if any; and (x) procedures for financial valuation of SOEs. SCIs will help alleviate the problem associated with management expanding or reducing SOE activities without the appropriate mandate.

74. In conjunction with SCIs, the Government as shareholder will enter into formal appointment agreements with all newly appointed commissioners and directors. These contractual arrangements can be documented in the minutes of the shareholder meeting. The Government has announced the appointment criteria, roles, responsibilities, and accountability of BOCs and BODs.[37] The appointment agreements will foster autonomy of SOEs and accountability of supervisors and management by establishing individual and collective roles and responsibilities for implementing the SCI. In addition, MSOE will review and comment on the composition of the BOCs and BODs, including the number of members, and their skills mix and qualifications.[38] A new performance incentive system will be introduced for all SOEs to reward management and staff for improvements in defined performance indicators.

75. For a rigorous system of accountability to work, MSOE officials and SOE commissioners and directors must be highly qualified professionals. Therefore, with ADB support (footnote 5), training has been provided, in effective corporate governance mechanisms and will continue under a new TA (footnote 6). So far, 60 officials and SOE management and staff have received this training and another 120 will be trained by 2002. MSOE will review the performance of the first group of SOEs that have received the training and implemented SCIs and appointment agreements for at least one year.

76. In addition to establishing clear accountability, the Program will radically improve transparency and disclosure of financial accounts of SOEs. Corporate secretaries will be responsible for providing mandated corporate information to the public. The Government will enforce strict application of accounting standards by SOEs in accordance with an agreed timetable. A total of 78 SOEs will be subjected to independent (non-BPKP) three-year financial audits. In addition, it will encourage rigorous application and enforcement of disclosure standards recently prescribed by the Government. Sound disclosure standards, uniform application of Indonesian GAAP for the preparation of annual reports under the supervision of audit committees at the BOC level, and submission of such reports in accordance with legal requirements will enhance transparency and improve governance.

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[37] Decree of the Minister of Finance No. 146/KMK.05/2001

[38] The review will include the role, obligations and composition of BOC and BOD to verify whether BOC has guided and monitored the implementation by BOD of (i) SOE's long-term plan, (ii) annual business plan, and (iii) budget.

77. The Program recognizes the important role of listed SOEs for improving the quality of corporate governance in Indonesia's private sector. MSOE will ensure that listed SOEs will move to comply with the listing rules of JSE, in particular with the following provisions on corporate governance:

(i) appointment of independent commissioners in proportion to the number of shares held by noncontrolling shareholders;
(ii) establishment of an audit committee comprising at least three members, one of whom is an independent commissioner and the others independent professionals in accounting and/or finance recruited from outside the company; and
(iii) appointment of a corporate secretary, who must be a member of the BOD or a corporate officer specifically appointed to this function.

2. Public Service Obligations

78. The Program supports the separation of PSOs from the purely commercial activities of SOEs. To this end, MSOE will (i) identify PSOs in all SOEs; (ii) quantify the monetary value of performing PSOs in 15 SOEs; (iii) develop rules and regulations for contracting such services on a competitive bidding basis, allowing participation by private companies; and (iv) commercialize PSOs in selected SOEs. The objective is to establish a transparent process for the separation of PSOs with due consultation of all stakeholders. A precondition for carrying out (ii) is the introduction of cost accounting in the concerned SOEs. This helps to quantify the costs of providing PSOs, and will allow to estimate the value of the commercial operations of SOEs, thus facilitating the privatization process.

79. MSOE will cooperate closely with relevant sector ministries to introduce these rules and regulations, and support the contracting out of selected PSOs to the most competitive bidder, which may not necessarily be the SOE that had previously been providing the services. The contracting process will give due consideration to compliance with social and environmental legislation in technical specifications. ADB is supporting these reforms with TA (footnote 7).

80. International experience has demonstrated that PSOs can be most efficiently provided when a competitive environment exists. This requires quantification and packaging of PSOs as concessions or service contracts and offering them in public tender to the most competitive bidder. Such a contracting process will allow the Government to accurately measure the cost of PSOs and ensure that their provision is contracted to the most efficient supplier. This will facilitate the creation of a transparent system of (i) subsidies for socially desirable, but economically nonviable services whose cost can be fully quantified and financed explicitly from the Government budget; and (ii) bidding for the provision of such services by private companies through predefined and transparent rules and procedures.

81. The Government has identified 15 SOEs with significant PSOs. Among them are Indonesia's ports, which are operated by four SOEs, each of which has one potentially profitable port combined with 8 to 15 smaller regional ports that operate with losses. Similarly, all airports are operated by either of two SOEs, with one profitable international airport each (Jakarta and Denpasar) and several loss-making regional airports. Privatization options for these 6 SOEs are to sell them entirely, which involves the risk that the new owners might close the losing regional operations later, with unacceptable political and socioeconomic consequences. Another option, currently pursued by the Government for the airports and already applied to the container terminals of the Jakarta and Surabaya seaports, is to separate the profitable operations from the SOE and sell them to private operators or form joint ventures with private investors to operate them separately. This option has the risk that the SOEs will no longer generate sufficient profits

to cross-subsidize the loss making ports and airports. A third possibility, to be pursued under the proposed Program, is to separate the non-profitable operations, which are in most cases PSOs, from the commercial operations, and find alternative delivery systems for them, including transparent subsidization. The commercial operations can thus be sold without endangering the future provision of PSOs.

3. Corporate Restructuring and Privatization

82. Given the size and complexity of SOE restructuring, the Program, together with the ADB financed TA (footnote 6) applies a common analytical framework[39] that (i) prescribes guidelines for assessing the financial and commercial viability of SOEs, (ii) develops a financial and operational restructuring strategy for SOEs with feasible options for privatization, and (iii) determines financial and economic costs associated with the restructuring. Based on the work already undertaken by the Government, the Program calls for (i) financial and operational restructuring of 30 SOEs to prepare them for privatization, (ii) privatization of 15 SOEs, (iii) sale of the minority shareholding in 12 companies, and (iv) initiation of liquidation of 8 nonviable SOEs.

83. In contrast to this new approach, which is based on analysis and strategy, the first privatization attempts in 1998 and 1999 were of an ad-hoc nature, focusing predominantly on fiscal considerations. The Government planned to restructure and partially privatize 12 of the largest SOEs in the telecommunications, mining, cement, airport and seaport, toll road, steel, and plantation sectors, and to divest one minority shareholding, PT Indofood, in the first round between May 1998 and March 2000. Privatization of these large infrastructure SOEs was part of the World Bank's Policy Reform Support Program (footnote 35). However, weak market conditions, the complexity of various industries, inadequate regulatory structures in infrastructure sectors, and lack of experience prevented the Government from completing this first round by the end of March 2000.

84. In recognition of these difficulties, the Government requested TA from ADB to put the privatization program on a solid basis. With support of consultants under the ADB-financed TA (footnote 5), the Government has undertaken substantial analytical and legal background work to relaunch its SOE privatization and governance program. In December 1999, MSOE started to screen all 117 SOEs and 21 minority shareholdings. By the end of February 2000, financial and business plan reviews were completed for 43 SOEs and 12 minority shareholdings identified as privatization targets. Based on this assessment, the quantitative targets for the Program have been developed (Appendix 3), and the Government documented its commitment by publishing them in the form of a masterplan for SOE reform.

a. Corporate Restructuring

85. The Program targets the corporate restructuring of at least 10 commercially viable SOEs by September 2002 and another 15 by September 2003. Financial restructuring of SOEs can involve (i) selling subsidiaries and/or surplus assets, (ii) equity injection from third parties, (iii) mergers of SOEs, and (iv) debt restructuring. Operational restructuring can involve changes in (i) management information systems; (ii) production and logistics planning; (iii) distribution network; (iv) marketing strategy; (v) workforce number and composition; and (vi) organizational structure. It can also involve separation of PSOs from commercial activities. The restructuring and eventual privatization of SOEs will be conducted in a transparent manner to attract private sector investors who can inject new capital in viable SOEs. MSOE will continue to develop the

[39] The analytical framework has been developed under a previous ADB financed TA (footnote 5).

restructuring plans with the support of two new TAs (footnotes 6 and 7). Where possible, the SCI will contain a time-bound action plan and targets for improving financial performance and implementing the selected restructuring option for the given SOE. As SOEs should be able to attract strategic investors, restructuring will commence immediately to pave the way for privatization under the Program. If appropriate, MSOE will assist in improving their balance sheets through debt-equity swaps and similar measures, but will leave it to the private sector investors to finance new investment to expand or modernize production facilities. In the case of both PT Indofarma and PT Biofarma, the proceeds from the initial public offerings remained with the companies to finance modernization and expansion.

86. Financial restructuring is expected to be facilitated by recently introduced legal reforms such as (i) removal of the Company Law restrictions on the conversion of debt to equity; (ii) removal of tax disincentives for restructuring, such as the failure to recognize mergers as tax neutral events and limits on loss carry-forward provisions; and (iii) simplification of procedures for debt restructuring of MOF, MOM, Ministry of Justice, Ministry for Industry and Trade, and Investment Coordinating Board.

b. Privatization

87. The Program targets satisfactory progress in the following two areas: (i) privatization[40] of 7 SOEs by March 2003 and another 8 SOEs by March 2004, and (ii) disposal of the minority shareholdings in 5 companies by March 2003 and a further 7 companies by March 2004. To ensure smooth and transparent privatization, MSOE has developed an analytical framework and evaluation methods for SOE privatization under ADB-financed TA (footnote 5). MSOE has further reviewed the legal and regulatory environment, including the Tax Law and Land Law, and prepared procedures for the various privatization options such as IPO, employee/management buy-out, strategic sale, and sale to an existing investor, as well as for liquidation. Together these provide MSOE with a sound legal and procedural base for SOE restructuring and privatization.

88. The ADB-financed TA (footnote 6) will assist MOF in selecting the best privatization option for the sale of the selected SOEs. The relative merits of each option will be weighed against the Government's objectives for the transaction, which may include maximizing revenue; preserving employment; accessing new technologies, markets, and know-how; and securing investment commitments. In cases where the objective of the Government is to access new technology/know-how and secure investment commitments, sale to a strategic investor will be the most appropriate privatization option. Where the Government seeks to maximize proceeds and foster the development of the domestic capital market, sale via IPO may be more effective. In all cases, the question of labor retrenchment will need to be addressed as a part of transaction negotiations, because any obligations imposed on the investor to retain surplus labor will depreciate the transaction value of the company. Once the privatization options have been defined and assessed for each SOE, MSOE will recommend the best sales strategy and an action plan and timetable for its implementation to the steering committee (para. 106). The recommendation will be supported by an assessment of its effectiveness in meeting the Government's objectives for the transaction, as well as their financial, economic, and regulatory implications. The implementation itself will be approved and supervised by an evaluation team at minister level.

[40] Defined as a reduction in the Government's share in the voting shares of a company (held directly or indirectly) to less than 50 percent.

c. Closure and Liquidation

89. Under the Program, MSOE will provide a time-bound plan and initiate liquidation of 8 nonviable SOEs by December 2002. The decision to close nonviable SOEs that are not of strategic significance and had generated operating losses even before the 1997 financial crisis, will be preceded by a thorough review. Generally, closure of SOEs will be considered if they (i) use obsolete technology; (ii) lack competitive advantage; (iii) face declining demand and market for products; (iv) have weak management; (v) had already performed poorly before the crisis, with the result that their equity has been wiped out; (vi) would require a complete diversification and/or overhaul of plant, equipment, marketing strategies and management expertise to return to profitability; and (vii) would have a cost of rehabilitation exceeding the value of the potential proceeds from their privatization. Liquidation of such SOEs is the most cost efficient option.

4. Labor Redundancies

90. The restructuring and privatization of SOEs will entail a reduction in staffing, a process that has already begun in some SOEs. According to preliminary estimates under ADB-financed TA (footnote 5), the level of overstaffing is about 10 percent. In most SOEs, management is reluctant to reduce the workforce, particularly skilled workers the SOE has provided with vocational training. However, most redundancies will be low-skilled workers. In some manufacturing and agricultural SOEs, women could suffer disproportionally.

91. The impact of corporate restructuring and privatization will differ from SOE to SOE. In quite a number of them, new ownership and management will lead to an expansion of activities, and the total workforce will increase in the longer term. Examples are the utility companies with restricted access to capital markets under state ownership, plantations that will expand into processing, and companies in the pharmaceutical and chemical industries. Other enterprises, particularly smaller ones, may be viable in the long run only with a permanently reduced workforce. For some, liquidation will be the only recourse, and retrenched workers will have to seek employment elsewhere. The Program puts a strong emphasis on mitigating these negative consequences. International experience shows that mass redundancies have to be treated individually and that legal provisions can only serve as a framework for negotiations between management and employees or their representatives. The latter have a right to full information and fair negotiations, which aim at creative solutions beyond severence payments to ease the transition. This is best achieved through a process involving the provision of information followed by consultations and then negotiations. Appendix 4 gives examples of recent retrenchment settlements and evolving best practices.

92. The Program will support MSOE's efforts in developing a labor rationalization policy to ensure fair treatment of redundant SOE employees by using the best practices developed in the SOE sector and compliance with the existing legal standards specified in Presidential Decree 3/1996. MSOE, with assistance from ADB-financed TA (footnote 6), will ensure that adequate information is disseminated to employees and a structured process of consultation and negotiation is followed. For this purpose, MSOE will establish a consultative working group on labor redundancies, with representation from Government, SOEs, and unions, to manage seminars and workshops on labor legislation,[41] and foster dialogue between labor unions, SOE management, and MSOE. The labor rationalization policy will cover (i) severance and service payments; (ii) early retirement; (iii) assistance in redeployment, training, or retraining of workers, and financing of entrepreneurial initiatives; and (iv) employee rights in accessing their claims

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[41] Currently there are three new laws before Parliament, the Trade Union Act, Dispute Settlement Act, and Manpower Development Act.

against pension funds. Within this policy framework, SOEs will submit their individual labor rationalization plans (including costs) to MOM for approval. MOM will maintain disbursement records of financial assistance provided by SOEs or by the Government through SOEs unable to meet the cost of redundancies, and will develop dispute procedures allowing employees to lodge complaints and initiate litigation where justified.

5. Procurement

93. The Program will support the Government's anticorruption campaign through the application and enforcement of appropriate rules and regulations in the area of SOE procurement. It will continue the precedents set by audits of Government business units agreed to under the IMF program. The first set of audits were conducted in the first half of 1999 for Pertamina, PLN, Agency for National Logistics (BULOG), and the reforestation fund. A second series of audits was started in January 2000 covering the national airline, port companies, the telecommunication company, and others. SOEs' procurement is guided by Presidential Decree 18/2000, which are applicable to all public sector projects (and consistent with ADB's *Procurement Guidelines*). MSOE will ensure that SOEs follow procurement procedures as prescribed by these public sector regulations. MSOE will (i) require compliance of SOEs with transparent and fair procurement practices ensuring full accountability; (ii) undertake random audits of procurement in 40 SOEs, present audit reports to ADB, publish a summary of findings, and initiate measures to recover losses and prosecute culprits; and (iii) based on the results of the random audits, improve the detailed procedures for the procurement by SOEs, differentiated by industry groups if necessary.

D. Economic, Social, and Environmental Issues

1. Economic Impact

94. Indonesia is pursuing a structural adjustment program supported by ADB, IMF, and World Bank, which covers wide-ranging economic reforms including banking sector restructuring, capital market development, trade liberalization, industry deregulation, legal reform, state sector reform, and improvements in governance. The Program is an integral part of this overall reform agenda as it introduces and enforces sound corporate governance practices, improves the enforcement of commercial laws and regulations, promotes fair treatment of redundant employees, reduces corruption in procurement by SOEs, and supports the transformation of viable SOEs into modern and profitable companies.

95. The Program will have a profound impact on the overall economy in five areas. First, by setting high standards in corporate governance, human resource management, and anticorruption measures, it will create a model to be emulated by the private sector. Second, through promoting best practices in debt restructuring, the Program will provide good examples for the private corporate sector as well, and thereby support the work of IBRA and JITF. Third, corporate restructuring of SOEs will result in the development of healthier enterprises, relieving the burden on and risk for public sector finances and the banking sector, which is exposed to nonperforming loans to SOEs. Fourth, the proceeds from SOE privatization will benefit the budget, providing funds for social projects, bank recapitalization, and debt service. Fifth, the privatization of sound SOEs will attract foreign investors back to Indonesia and thereby help restore international confidence.

96. The economic impact of the Program will be monitored and assessed on the basis of (i) reports from SOEs to MOM on redundancy agreements with employees; (ii) procurement audit reports prepared by independent auditors; (iii) reports from MSOE on compliance with the

corporate governance system; (iv) annual reports submitted by listed SOEs to JSE and by the other SOEs to MSOE and the Company Registrar; (v) reports from MOF on the progress of privatization; and (vi) reports from the stock exchanges Jakarta and Surabaya on the success of IPOs of SOEs.

2. Social Impact

97. A detailed assessment of the Program's impact on poverty is given in Appendix 4. By improving corporate governance and mitigating the impact of labor redundancies, the Program supports two key pillars of ADB's poverty reduction strategy: good governance and social development. Moreover, by increasing SOE efficiency and through privatization, the Program will help mobilize additional fiscal resources and thereby facilitate allocation of additional public funds for poverty reduction. The Program addresses also the third pillar of ADB's poverty reduction strategy: pro-poor sustainable economic growth. SOEs have been a drain on the budget and a drag on economic growth. The inefficiency, corruption, and waste in many SOEs have left the Government with insufficient resources to provide the requisite level and quality of public services and to launch antipoverty programs. The Program will support the transparent use of public funds and efficient delivery of public services. Their economic efficiency will be increased by applying a range of tools including improved management, introduction of competitive markets, public-private partnerships, and privatization.

98. While the Program will facilitate the return to sustainable growth, it is likely to have an adverse social impact, at least in the short run, as SOE restructuring will result in redundant labor. The 10 percent overstaffing in the SOE sector represents about 70,000 employees. Surplus labor exists both at the management level where firms have undergone mergers (such as in the plantation industry) and at lower levels where changes in technology have reduced the need for low skill labor and necessitate a different skill mix. Most layoffs are likely to affect workers with low level skills, who will be less likely to find equivalent employment in the formal sector. Legally mandated severance standards are adequate. Negotiated settlements tend to be in excess of these minimum standards. Compared to the private sector, SOE employees are at a disadvantage in such negotiations, as prior to 1999 they were not allowed to unionize or engage in collective bargaining. As a result they have little practical experience in negotiating their interests with management. And, SOE management has had little experience in dialogue with labor on employment and employment-related issues.

99. The Program puts a strong emphasis on establishing a consultative working group on labor redundancies (para. 92) comprising representatives of all stakeholders to develop the labor rationalization policy for MSOE. The consultative working group will develop standards of best practices in negotiating settlements, serve as a conduit for information for labor representatives, and provide a forum for policy discussion regarding unresolved labor issues such as the treatment of contract labor.[42] The Program thus provides a channel for workers and their representatives to participate more fully and in an informed way in a dialogue to ensure their best interest. Similarly, the corporate governance measures will result in better management and fairer treatment of labor and ultimately greater efficiency and returns to public investment, growth, and poverty reduction.

100. The measures under the Program support strengthening the system for social protection in Indonesia. ADB, through a TA (footnote 6), will play a significant role in assisting MSOE to develop policies for a retrenchment process based on best practices evolving within the SOE

[42] Public and private sector firms have used contract labor for routine and essential jobs. Labor regulations prohibit firms from using contract labor for this purpose for longer than one year, a rule that is routinely ignored. Moreover, some public sector firms such as the oil and gas industry have been exempt from this by ministerial decree.

sector and internationally. This will help (i) ensure that workers receive an equitable compensation package, and (ii) resolve issues regarding entitlement to employer contribution to pension funds, unfunded liabilities, payouts for SOEs with insufficient funds, potential burden on pension funds, and any issues that may arise from excessive use of contract labor. The processes adopted by SOEs and agreements reached will provide examples for the private sector struggling to deal with its own retrenchment programs.

3. Environmental Impact

101. A detailed assessment of the Program's potential environmental impacts is given in Appendix 5. SOEs generally adhere to the Government's environmental regulations in their operations. The three mining companies, for example, have environment protection policies in place, which are rigorously enforced. These policies have been adopted from Australian standards, and adherence to them is continuously monitored. PT Krakatau Steel and fertilizer companies voluntarily apply pollution control in line with international best practices. The manufacturing companies are generally certified under ISO 9000, which encourages the application of environmental standards in production facilities and use of efficient and clean production techniques. In some cases, SOEs are actively pursuing environmental protection and rehabilitation or are required to do so under PSOs. The fishing companies, for example, have been assisting in the protection of marine reserves. The forestry companies support reforestation, forest rehabilitation, and the development of ecotourism opportunities.

102. The TA for commercialization of PSOs (footnote 7) is designed to ensure continuing provision of such beneficial environmental services in a cost efficient manner. The rules and regulations for contracting out such services will give due consideration to compliance with environmental legislation in the technical specifications. The Program does not envisage investments in additional production capacity. After privatization, the new owners may expand production, which may widen the environmental impact of the existing production sites. However, any such new investment will have to comply with the existing legislation. During the financial and operational review of the SOEs, MSOE, with assistance from the ADB-financed consultants, will recommend a special assessment of compliance with environmental legislation where appropriate. Furthermore, in any privatization, including environmentally sensitive enterprises, the Government can retain the so-called golden share, which will allow it to influence future investment decisions or to enforce environmental regulations. The major instrument of corporate governance, the SCI, will require all SOEs to report regularly on compliance with environmental legislation, and, where appropriate, this will have to be confirmed through appropriate certification by an accredited agency. Additionally, the performance incentive system can be used to improve environmental performance by basing it on environmental indicators or achieving certification by an accredited agency. Finally, the new guidelines for procurement to be developed under the Program will include requirements for compliance with environmental standards.

VI. THE PROPOSED PROGRAM LOAN

A. Amount of Loan and Source of Funds

103. A $400 million program loan is proposed from ADB's ordinary capital resources to support the Program as described in the development policy letter and the attached policy matrix (Appendix 1). The Borrower will be the Republic of Indonesia. The loan will be utilized over a period of 3 years from the date of its effectiveness. The loan size has been determined by the complexity of the Program, its development impact, and the adjustment costs related to

the structural reforms. The costs are conservatively estimated at $800 million during the three-year program implementation period and include

(i) costs for labor redundancies across SOEs that are not to be liquidated and that will retrench about 10 percent of their current staff (about $170 million);[43]
(ii) unfunded pension fund liabilities of the redundant workforce to be laid off and employees in companies to be liquidated or privatized (about $130 million);
(iii) debt restructuring costs for up to 60 SOEs, including debt-for-equity swaps, and the settlement of long-term foreign exchange debt (about $420 million); and
(iv) liquidation of 8 nonviable SOEs and settlement of their outstanding financial, trade, and tax debts, and wage claims (about $80 million).

The adjustment costs significantly exceed the amount of the Program loan. The difference will be financed by the Government partly out of the proceeds of privatization transactions.

B. Interest, Maturity, and Utilization Period

104. The loan will have a 15-year term, including a grace period of three years, an interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a commitment charge of 0.75 percent per annum; a front-end fee of 1.0 percent (the fee will be capitalized in the loan); conversion options that may be exercised in accordance with the terms of draft Loan Agreement, the Loan Regulations, and ADB's Conversion Guidelines; and other terms and conditions set forth in the Loan Agreement. The Government has provided ADB with (i) reasons for Indonesia's decision to borrow under ADB's LIBOR-based lending facility on the basis of these terms and conditions, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice of ADB.

C. Implementation Arrangements

105. MOF will act as the Executing Agency to coordinate and monitor the overall implementation of the Program, and administer the utilization of loan proceeds. MSOE will be the Implementing Agency and will coordinate with other agencies as required. MSOE will provide quarterly reports on the progress of the Program.

106. To monitor the progress, the Government will establish a high-level steering committee with representation from MSOE (chairperson), MOF, the Coordinating Ministry for Economy Affairs, the National Development Planning Agency (BAPPENAS), and MOM. The committee will review SOE restructuring and privatization strategies and endorse these or recommend changes if required. The primary authority for approving the strategies will remain with MSOE. The steering committee will conduct quarterly reviews of program implementation and will be supported by a corporate governance and privatization working group established within MSOE to closely oversee the development and implementation of financial and corporate restructuring, privatization, and the new corporate governance policy in the targeted SOEs, as well as implementation of TA (footnote 6). A separate working group will oversee the implementation of the TA for commercialization of PSOs (footnote 7). The steering committee will be further supported by a consultative working group on labor redundancies.

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[43] Surplus labor of 10 percent in the SOE sector is equivalent to 70,000 people. Given an average wage of $186 per month and legal minimum requirements for severence payments (footnote 30), this is about $174 million. Taking recent settlements of the SOEs PT Garuda (national airline) and PT IPTN (aircraft manufacturer) as a benchmark, the cost may exceed $220 million. Applying the settlements reached between IBRA and the employees of closed banks, the costs could even exceed $280 million.

D. Procurement and Disbursements

107. Upon effectiveness, ADB will have the right to withdraw from the loan account and pay itself, on behalf of the Government, the front-end fee charged on the loan in the amount of $4 million. The proceeds of the balance of the loan will be utilized to finance the foreign exchange costs of items produced in, and procured from, ADB's member countries (other than those items specified in Appendix 6 and imports financed by other bilateral and multilateral sources, including other loans made by ADB). The Government will certify that, if (i) the proceeds of the loan will finance imports already made, the value of eligible imports in the period concerned exceeds the amount of the requested withdrawal; or (ii) the loan proceeds are to finance goods to be imported, the value of eligible imports in the immediately preceding year period is equal to or greater than the amount of the requested disbursement plus all other amounts expected to be withdrawn from the loan during the succeeding one year. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Government's certification.

E. Counterpart Funds

108. The Policy Matrix for the Program includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated out of the loan proceeds will be used by the Government to finance the cost of such structural adjustments, as well as other activities consistent with the Program.

F. Monitoring and Tranching

109. The program period will be three years from December 2001 to December 2004. The loan will be disbursed in three tranches. The first tranche of $150 million[44] is expected to be made available upon loan effectiveness. The Government has completed all first tranche conditions prior to loan negotiations.

110. The second tranche, amounting to $150 million, is expected to be released by July 2003, on completing the following six actions:

- (i) appointment agreements for all newly appointed directors and commissioners will have been signed;
- (ii) 35 SOEs will have submitted SCIs to MSOE;
- (iii) 80 percent of SOEs will have filed annual reports complying fully with legal disclosure requirements for listed companies with MSOE and the Company Registrar;
- (iv) independent (non-BPKP) three-year financial audits for 30 SOEs will have been submitted to ADB;
- (v) satisfactory progress will have been achieved in the
  - (a) privatization of 7 SOEs, and
  - (b) sale of Government shares in 5 minority shareholdings; and
- (vi) reports of procurement audits of 20 randomly selected SOEs will have been presented to ADB.

111. The third tranche, amounting to $100 million, is expected to be released by July 2004, upon completing the following six actions:

[44] Upon effectiveness, ADB will withdraw from the loan account and pay itself, on behalf of the Government, the front-end fee charged on the loan in the amount of $4 million.

(i) appointment agreements will have been signed for all newly appointed directors and commissioners;
(ii) 50 SOEs will have submitted SCIs to MSOE;
(iii) 80 percent of SOEs will have filed annual reports complying fully with legal disclosure requirements for listed companies with MSOE and the Company Registrar;
(iv) independent (non-BPKP) financial audits will have been submitted to ADB for 30 SOEs;
(v) satisfactory progress will have been achieved in the
    (a) privatization of 8 SOEs, and
    (b) sale of Government shares in 7 minority shareholdings; and
(vi) reports of procurement audits of 20 randomly selected SOEs will have been presented to ADB.

112. An additional 26 monitorable policy actions will be carried out during the program implementation. Most of them are important steps toward achieving conditions for the release of the second and third tranches.

113. The steering committee will assess the implementation of the Program and, through MOF, provide ADB with quarterly reports on the progress in all five program areas, including the progress in quantitative terms in conditions for the next tranche release. After receiving the steering committee reports, ADB will send regular review missions to assess compliance with such conditions and advise on corrective actions required to keep the program implementation on course. The Government will submit a program completion report to ADB at the end of the program period.

VII. PROGRAM BENEFITS AND RISKS

A. Program Benefits

114. The proposed Program is an integral part of the Government's comprehensive efforts to address the long-standing distortions in the Indonesian economy. Its central objective is to improve resource allocation in the public sector by making SOEs efficient and profitable, thus allowing them to pay higher dividends and corporate taxes to the Government. These revenues, together with the proceeds from the privatization of SOEs, will help alleviate budgetary pressures and allow the Government to meet priority expenditure on social programs and social safety net.

115. The Program prescribes rigorous corporate governance mechanisms, based on international best practices, and enforces legal and regulatory requirements to improve the accountability and transparency of SOEs. This will help the Government gain the necessary authority to enforce better corporate governance throughout the corporate sector. Strengthened corporate governance in SOEs will be reflected in improved transparency in dealings with shareholders, lenders, employees, and other stakeholders in listed companies. The listing of a number of SOEs on the JSE in the future will set good examples for observance of corporate governance, and will generate the necessary market pressure on other listed enterprises to implement the same improvements.

116. Corporate governance is not an issue of regulation, but one of enforcement. Of the 288 companies listed on the JSE, 244 companies are majority owned by large conglomerates with the attendant lack of transparency and absence of accountability to minority shareholders. Their financial statements do not reflect the risk exposure as a part of the conglomerate and do

not allow an assessment of the company's credit worthiness or of shareholder value. This has contributed to a loss of confidence of international institutional investors in Indonesia. The listing of a large number of additional SOEs will increase the supply of quality securities on JSE and will allow investors to make more informed decisions. This should enhance market discipline in JSE and reduce volatility in the equity market in the long run. A related benefit is that increased investor confidence will ease IBRA’s task of disposing of a large part of its assets into the equity market.

B. Poverty Impact

117. In the longer term, successful restructuring and privatization will increase job security for the employees in many of the SOEs. Without Government ownership, and resulting relationships with state-owned banks, many of these companies would be bankrupt by now. However, with the new banking regulations now in place, these cozy relationships are about to end. SOEs will now have to compete for credit as do their private sector counterparts. SOEs that do not restructure are not likely to survive competition. A group of SOEs has been hit very hard by trade liberalization during the past years. In particular those active in manufacturing and processing of agricultural goods, such as sugar mills. Not only are they in a vulnerable financial position, but are also not internationally competitive. Only rapid privatization, accompanied by injection of capital and know how, can make them more competitive and improve their chances for survival. The Government neither has the capital nor the capability to continue their operation.

C. Program Risks

118. The implementation of the Program can be affected by several factors. The principal risk relates to political uncertainty and its effect on the pace of structural reforms. However, there is a firm commitment to SOE reforms at the highest levels in the new Government, and consequently, the risk of the Program being diluted or abandoned is limited.

119. The second risk stems from the potential opposition of vested interests. For instance, all members of BOCs of SOEs are public servants—many with limited relevant skills—for whom the monetary and fringe benefits of the position provide a source of considerable income. Corporate restructuring and the subsequent privatization will involve significant changes in the composition of BOCs and, hence, a loss of position, income, and associated social prestige. Furthermore, many sector ministries have traditionally used SOEs as an additional source of revenue to finance part of their expenditures and have enjoyed wide ranging benefits which will be withdrawn. To counter resistance from these vested interests, the proposed system of corporate governance is designed to give BODs greater authority and autonomy, thereby reducing their willingness to collude with incompetent BOCs. Furthermore, the appointment agreements for directors and commissioners will change the incentive system for both groups by linking incentives to actual performance.

120. The third risk relates to the lack of capacity within the Government to effectively oversee and monitor SOE reforms and restructuring, and implement them in a timely and effective manner. The major bottleneck could be MSOE as it is lacking experience in these areas. To mitigate this risk, ADB has provided TA to enhance MSOE's capacity in financial and operational analysis, corporate restructuring, legal aspects of restructuring and privatization, and corporate governance (footnote 5). Additional TA will be provided in conjunction with the Program to ensure continued momentum in this capacity building efforts (footnote 6). The Program also prescribes strict accountability on the part of members of BOCs, who have traditionally been selected from the ranks of bureaucrats and retired military, without

necessarily having qualifications in accounting, management, or law. While there are examples of BOC members with adequate qualifications who are performing satisfactorily, many current members will not be able to cope with their new responsibilities. The Program will alleviate the problem in two ways. First, MSOE will review of the capabilities of the BOC members. Those with no relevant skills will be replaced. Second, necessary training will be provided to the remaining BOC members.

VIII. ASSURANCES

121. In addition to the standard assurances, the Government has given the following assurances, which have been incorporated in the legal documents:

(i) the policies adopted and actions taken prior to the date of Loan Agreement, as described in the development policy letter and the attached policy matrix (Appendix 1), will be in effect for the duration of the program period;
(ii) corporate restructuring and privatization of SOEs will be undertaken in a fair, transparent, and (to the extent commercially practicable) competitive manner, and only after a thorough analysis of the benefits of the chosen restructuring option has taken place; and the Government will make the necessary funds available for debt restructuring of SOEs in a timely manner;
(iii) the Government shall ensure that MSOE is provided with appropriate budgetary allocations to cover expenses relating to (i) dissemination of corporate information from SOEs (including annual reports and SCIs) through print media or the Internet, (iii) dissemination of information about the Program through the Internet, (iii) engagement of procurement and financial auditors, and (iv) engagement of advisors for privatization transactions and debt rescheduling negotiations;
(iv) labor retrenchments will be carried out in accordance with the laws of Indonesia, and the Government will make the necessary funds available for voluntary retirement schemes in a timely manner;
(v) public awareness campaigns will be developed and implemented to advertise the benefits of the privatization program; and
(vi) proceeds from the loan will not be utilized for SOE investment in modernization and capacity enlargement.

IX. RECOMMENDATION

122. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan of $400,000,000 to the Republic of Indonesia for the State-Owned Enterprise Governance and Privatization Program from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's LIBOR-based loan facility, an amortization period of 15 years, including a grace period of 3 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

TADAO CHINO
President

8 November 2001

APPENDIXES

MIMSTER OF **FINANCE**
OF THE REPUBLIC OF INCONESIA

Jakarta, October 31, 2001

Mr. Tadao China
President
Asian Development Bank
Manila, Philippines

Re: Development Policy Letter

Dear Mr. President,

1. The economic crisis that affects Indonesia since late *1997* brought to an end three decades of uninterrupted economic growth. The crisis has crippled the economy. It dislocated the stable macroeconomic structure before the crisis due in part to the huge debt increase brought about by the currency depreciation. The crisis also triggered a political transition during that period. Subsequent political changes in our difficult transition to a parliamentary democracy also affected our efforts to stabilize the economy.

2. Since the crisis, the International Monetary Fund has been assisting us in designing and implementing a macroeconomic stabilization program to restructure our economy and make it more open, competitive and sustainable. The Asian Development Bank, World Bank, and other development partners had worked closely with the IMF to support cur restructuring efforts that included substantive reforms in the real sector and public sector governance.

3. The Asian Development Bank has been at the forefront during the crisis with its assistance to the financial sector. The loan complemented the IMF and WB financial sector reform program, including bank recapitalization. This loan also supported efforts to improve financial governance and development of the capital market. Over the past four years, the ADB also extended valuable support for our efforts in decentralization, power sector, industrial and trade liberalization and in education, agriculture, and poverty programs. The ADB technical assistance program has also improved governance through an audit program in the state attorney department and legal support for establishment anti corruption and anti monopoly commissions.

4. Although it has been four years since the crisis, our economic recovery remains fragile. Domestic political uncertainties have contributed to delays in implementing the reform programs. The election of Vice President Megawati Soekarnoputri to be the fifth president of our Republic in late July ended domestic political uncertainties. A new cabinet was appointed on 9 August. It quickly concluded a Letter of Intent with the IMF and resumed our relations with the international community including the successful conclusion of our Paris Club II arrangement. A draft FY 2002 budget was submitted and subsequently approved by the concerned parliamentary commission. However, the attack on US World Trade Center on 11 September and its impact on the global economy has placed at risk our efforts to sustain progress in economic recovery. This has strengthened our resolve to speed up our reform program including the state enterprise sector.

MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA

5. The reform of our state enterprise sector is an integral part of our overall recovery strategy to improve our economy's efficiency and competitiveness. The performance of our SOEs has deteriorated over the years. Poor financial management and supervision, weak governance structures, protected markets and monopolies are some of the reasons for the inefficiencies in these enterprises and many have continued to be a heavy burden on our budget.

6. The government has attempted to deal with the sector reform by transferring the responsibility for SOE administration from the Ministry of Finance to a new State Ministry for Empowerment in May 1998. A strategic goal of this ministry was to improve the performance of SOEs through restructuring and privatization. A technical assistance extended by the ADB contributed to the preparation of a Master Plan for SOE Reforms that was adopted by the government in May 2000. This Plan outlines the broad objectives, policies and guidelines on restructuring and privatization of SOEs. The State Ministry was dissolved in October 1999 with a change in government and the Ministry of Finance regained its supervision over SOEs. The SOE reform program was continued under the Ministry of Finance. The present government accorded high priority to SOE reform and a Ministry for State Owned Enterprises was reintroduced when the government took office in August 2001.

7. When the SOE reform program commenced in 1998, a group of 12 of the largest enterprises in the telecom, mining, cement, airports, seaports, tool roads, steel and plantation sectors were identified for priority restructuring and privatization. The experienced gained allows u~ to accelerate the reform process to improve enterprise efficiency, promote greater transparency and accountability and corporate governance. These are reflected in our program for systematic reform of the SOE sector.

8. This program contains five components:

(i) instilling improved corporate governance practices,
(ii) separating public service obligations from SOEs' commercial operations,
(iii) implementing corporate restructuring and privatization,
(iv) managing social impacts of SOE reforms, and
(v) introduce competitive and transparent processes of procurement.

9 The specific objectives and measures to be pursued under the Program are set out hereunder.

**MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA**

10. The Program will introduce sound practices for corporate governance—a broad set of incentives, structures, and procedures that will drive SOEs to act in the best interests of their ultimate shareholders — the public. A Statement of Corporate Intent will be the major instrument to enforce accountability of SOEs and will allow the Government to effectively uphold property rights. The Program will improve the quality and availability of SOE corporate information. This includes developing a timetable for complying with uniform accounting standards applicable to all SOEs, lodging timely information with the Company Register and piloting the function of a corporate secretary who will be responsible for providing corporate information to the public. The financial transparency of SOEs will be enhanced so that prospective investors can readily assess SOE investment opportunities. The accountability of Directors and Commissioners will be enhanced through contractual arrangements clearly outlining their rights and obligations.

11. The Program supports the restructuring and eventual privatization of SOEs in a structured and transparent manner. A systematic and analytical framework is already being applied to assess the financial and commercial viability of the SOEs and define their financial and operational restructuring needs. Based on the assessment, the Government will move to liquidate the commercially and financially non-viable SOEs, undertake appropriate restructuring of the commercially viable SOEs before privatization, and will implement plans of privatization for those SOEs which need to undergo only limited restructuring prior to privatization. Under the Program, the Government will continue the process of separating public service obligations from purely commercial activities of SOEs and putting in place a transparent system of explicit subsidies for socially desired services. The Program will also develop and introduce competitive mechanisms for publicly tendering contracts for these services.

12. The SOE restructuring and privatization is likely to render a significant number of employees redundant. The Program will establish a systematic process of consultation and negotiations on labor rationalization. A transparent policy will be developed to deal with redundancies, retraining and pension issues. Within the policy framework, SOEs will submit their individual labor restructuring plans to the Government, which will ensure the application of best practices in negotiations between employees and management.

13. The Program will have a strong anti-corruption thrust by applying and enforcing existing rules and regulations in the area of SOE procurement. Specifically, the Government will publicly announce that SCE procurements shall comply with the national procurement guidelines. The Government will also engage external auditors to conduct random audits of SOE procurement practices and will publish the audit reports.

MINISTER OF FINANCE
OF THE ~EPUBL~C QF INDONECIA

14. The State-Owned Enterprise Governance and Privatization Program as summarized above sets out the broad agenda for furthering the SOE restructuring and privatization. The Government is convinced that the comprehensive measures to be implemented under the Program along with the parallel structural reforms will pave the way for efficient and broad-based economic growth in the coming years. The two ADB technical assistance projects for privatization and restructuring of SOEs and commercialization of public service obligations will strengthen the government's efforts to reform the sector.

15. In addition to such advisory support, the SOE reform program will incur substantial fiscal cost for the reform of the sector. The fiscal constrain of the government will inhibit sustained efforts to reform the sector. In this connection, the government requests for a loan of $400 million from ADB to support the implementation of this program.

16. The government is committed to the timetable for implementation of the policy matrix on SOE Reform. The government will set up a Program Steering Committee to oversee program implementation. This group will include representatives from different ministries and agencies to improve coordination in the implementation of this program. The government will maintain an active policy dialogue with the ADB during program implementation, including introducing additional measures to ensure that the Program goals are met.

17. We look to working closely with the ADB to implement this important reform program.

Yours sincerely,

Boediono
MInister of Finance

Draft Policy Matrix
State-Owned Enterprise Governance and Privatization Program (SOEGPP)

Program Objectives: The proposed Program will improve resource allocation in the public sector, increase profitability of Indonesia's state-owned enterprises (SOEs), and promote private sector participation in the commercial activities of SOEs. Reform of SOEs, involving transfer of ownership and management, and confining the Government's role to policymaking and regulation, will release scarce resources for poverty reduction and social programs. This will be achieved by (i) subjecting SOEs to sound corporate governance practices, (ii) separating commercial activities of SOEs from their public service obligations (PSOs), (iii) restructuring and privatizing SOEs, (iv) establishing fair and transparent procedures for managing labor redundancies, and (v) strengthening and effectively enforcing guidelines for procurement in SOEs.

Policy Actions[1]	**Action completed (1998 to Nov 2001)**	**Second Tranche Conditions July 2003**	**Third Tranche Condition July 2004**
A. Corporate Governance			
1. For state-owned enterprises (SOEs) not listed on a stock exchange: Develop and strengthen the corporate governance policy framework for SOEs to empower the managers to create shareholder value under adequate supervision in a transparent environment promoting accountability. Introduce for SOEs a new corporate governance policy that will mandate: (i) appointment criteria, roles, responsibilities and accountability of the boards of commissioners (BOCs), and boards of directors (BODs) and templates for appointment agreements between the Government as shareholder through the general meeting of shareholders with the Commissioners. Likewise there will be templates for appointment agreements between the Government as shareholder through the general meeting of shareholders with the directors;[2] (ii) the use of statements of corporate intent (SCIs),[3] as a mechanism to implement and enforce transparency and accountability standards: the SCI will set out the objectives and scope of the SOE's activities, and define the business plan (including all corporate restructuring measures), accounting policies, performance targets, disclosure requirements, compliance with environmental legislation,[4] status of employees and compliance with laws and regulations regarding labor relations, and procedures to be followed before subscribing for, purchasing, or acquiring shares in other organizations; (iii) a performance incentive system (PIS)[5] to reward management for improvements in defined performance indicators.	May 2000		

[1] Dates in bold represent conditions for the release of second and third tranche.
[2] These contractual arrangements can be documented in the minutes of the shareholder meeting.
[3] The SCI will be prepared by the board of directors (company management), approved by the board of commissioners, and submitted to MSOE.
[4] Where appropriate, this will be confirmed through appropriate certification (e.g. ISO 14000) by accredited agency.
[5] The PIS will form an integral part of both SCIs and management contracts, linking management remuneration with achievement of performance targets outlined in SCI, with due consideration for commercial, labor, and environmental legislation.

Policy Actions	Action completed (1998 to Nov 2001)	Second Tranche Conditions July 2003	Third Tranche Condition July 2004
2. MSOE to implement corporate governance policy for SOEs not listed on a stock exchange through the following measures:			
(i) review and comment on the composition of the BOCs and BODs, including the numbers on the boards, and the skills mix and qualifications of the BOCs and BODs; [6]	Ongoing	Ongoing	Ongoing
(ii) negotiate and sign appointment agreements for all newly appointed directors and commissioners;		**Ongoing**	**Ongoing**
(iii) implement a PIS for remuneration of managers to reward for improvements in defined performance indicators by issuing Ministerial Decree;		March 2001	
(iv) prepare SCIs for the following number of SOEs: [7]			
(a) first group of 3 SOEs,	June 2000[8]		
(b) second group of 35 SOEs,		**September 2002**	
(c) third group of 50 SOEs; and			**September 2003**
(v) submit a performance review report (PRR) on implementation of corporate governance policy (appointment agreements, SCIs and PISs) covering SOEs with at least one year experience. PRR should include key benefits of contracting system and suggested areas of improvement.			March 2004
3. Ministry for State-Owned Enterprises (MSOE) to ensure that listed SOEs substantially comply with the listing rules of the Jakarta Stock Exchange, in particular with the following provisions on corporate governance:			
(i) appointment of independent commissioners in proportion to the number of shares held by noncontrolling shareholders;	October 2001	Ongoing	Ongoing
(ii) establishment of an audit committee comprising at least three members, one of whom is an independent commissioner and the others independent professionals in accounting and/or finance recruited from outside the company; and	October 2001	Ongoing	Ongoing
(iii) appointment of a corporate secretary: the position must be held by one member of the board of directors or a corporate officer specifically appointed to this function.	May 2001	Ongoing	Ongoing
4. Improve transparency of SOEs not listed on a stock exchange.			
(i) Create a new corporate secretary position for all SOEs to be listed during next 12 months. The secretary is to be appointed within 4 months of the expected listing date of the SOE, and will be responsible for corporate communications with shareholders, company registrar, and stock exchange.	Ongoing	Ongoing	Ongoing

[6] To include a review of the role, obligations and composition of BOC and BOD to verify whether BOC has guided and monitored the implementation by BOD of (i) SOE's long-term plan (ii) annual business plan, and (iii) budget.
[7] In selecting the SOEs, preference will be given to those that are not to be privatized during this Program.
[8] Developing SCIs and contractual arrangements in three SOEs, including reasonable performance incentive systems for SOEs applying new corporate governance policy.

Policy Actions	Action completed (1998 to Nov 2001)	Second Tranche Conditions July 2003	Third Tranche Condition July 2004
(ii) MSOE to require that all SOEs prepare an annual report[9] including statement on compliance with environmental legislation (where appropriate) and audited financial statements in line with existing regulations applying to (a) all companies with limited liability,[10] (b) companies whose line of business involves public fund-raising or who have assets of at least Rp50 billion or have issued an acknowledgement of indebtedness,[11] and (c) publicly listed companies.[12]	May 2000	Ongoing	Ongoing
(iii) At least 80 percent of SOEs under MSOE jurisdiction to file such annual reports complying fully with legal requirements stipulated above with MSOE and the company registrar.	October 2001[13]	**May 2003[14]**	**May 2004[15]**
(iv) MSOE to publish SCIs and annual reports (including audited financial statements) of SOEs with majority Government ownership on a specially designed web page accessible through the Internet. The system will also be used for SOEs to submit data and reports to MSOE.		ongoing	ongoing
(v) Establish audit committees in 30 SOEs (incl. one commissioner and two outside experts) that should report directly to the BOC to evaluate the audit results of the company, review compliance of company with statutory requirements and adequacy of audit procedures, and make recommendations about the internal control systems and their implementation.		October 2002	October 2003
5. Capacity building for effective implementation of corporate governance mechanisms by attending corporate governance workshops covering all items in A.1. organized with support of ADB, World Bank, or other providers, to be attended by at least			
(i) 40 MSOE directors and deputy directors,	February 2000		
(ii) all MSOE deputy ministers, directors, and deputy directors, and		June 2002	
(iii) commissioners and directors of 88 SOEs identified in A.2.(iv)		June 2002	
B. Public Service Obligations (PSOs)			
1. MSOE, with support of technical assistance for commercialization of public service obligations (PSOs), will			
(i) Identify PSOs in selected 15 SOEs,		June 2002	
(ii) Quantify PSO costs and environmental impact, and		October 2002	
(iii) Develop rules and regulations for tendering such services (allowing bidding by private companies) with the objective of minimizing subsidies.		October 2002	

[9] The annual report including the audited financial statements must be in accordance with the Company Law and with the Generally Accepted Accounting Principles (GAAP) approved by the Indonesian Institute of Accountants.
[10] Consistent with Company Law, articles 56, 57, 58, and 86.
[11] Consistent with the Government Regulation No. 24/1998 dated 14 February 1998 on Corporate Annual Financial Information.
[12] In line with the Decision of the Chairman of BAPEPAM No. KEP-80/PM/1996 dated 17 January 1996 on the Obligation to submit Periodic Financial Statements.
[13] For financial year ended 31 December 1999 and 2000.
[14] For financial year ended 31 December 2001 and 2002.
[15] For financial year ended 31 December 2003.

Policy Actions	Action completed (1998 to Nov 2001)	Second Tranche Conditions July 2003	Third Tranche Condition July 2004
2. MSOE to work closely with the relevant line ministries: (i) Introduce the rules and regulations for tendering PSO, by private companies with the objective of minimizing subsidies; and (ii) line ministries to contract[16] out the provision of selected public services[17] to most competitive bidder, that may or may not be the SOE which had been previously providing the services.			September 2003 March 2004
C. Corporate and Industry Restructuring			
1. Launch a major financial and operational review of at least 60 SOEs with the objective of (i) evaluating commercial and financial viability of firms and their business prospects, (ii) assessing labor retrenchment requirements, and (iii) recommending assessment of compliance with environmental legislation.	October 1999		
2. Develop policies and procedures and issue Ministerial Decree for the following privatization processes: employee buy-out, strategic sale, free share transfer, initial public offering (IPO), joint venture, leasing of operating assets, granting of concessions, share arrangement, and cash auction. This will include procedures for selecting auditors, investment bankers, and other technical advisors.		March 2002	
3. Based on the review in C.1. and with Asian Development Bank technical assistance for SOE privatization and restructuring: (i) Identify 12 nonviable SOEs and SOE business lines to be discontinued, (ii) MSOE to provide a time-bound plan and initiate liquidation of 8 SOEs.	May 2000	December 2002	
4. MSOE to implement corporate restructuring plans[18] for 30 SOEs identified under C.1., with appropriate consideration for all relevant legislation and policies stipulated under this program: (i) at least 5 SOEs, (ii) at least 10 SOEs, and (iii) at least 15 SOEs.	August 2001	September 2002	September 2003
5. Based on the review in C.1. above and in accordance with program implementation schedule, a complete independent (non-Financial and Development Supervisory Board), three-year financial audit that should include remuneration and all expenses (direct as well as fringe benefits) of the members of the BOC and BODs of (i) at least 18 SOEs, (ii) additional 30 SOEs, and (iii) additional 30 SOEs.	June 2001	**June 2002**	**June 2003**

[16] The contracting process (i.e. open tender) should give due consideration to compliance with social and environmental legislation in technical specifications.

[17] The TA team will identify SOEs where this is possible, and MSOE in cooperation with line ministries and ADB will determine the pilot cases.

[18] Corporate restructuring includes financial and/or operational restructuring. Financial restructuring could take one or more of the following options: (i) selling subsidiaries and/or surplus assets, (ii) equity injection from third parties, (iii) mergers or acquisitions, (iv) debt restructuring, and (v) liquidation. Operational restructuring could involve changes to one or more of the following: (I) management information systems, (ii) production and logistics planning, (iii) distribution network, (iv) marketing strategy, (v) workforce number and composition, and (vi) organizational structure.

Policy Actions	Action completed (1998 to Nov 2001)	Second Tranche Conditions July 2003	Third Tranche Condition July 2004
6. For SOEs identified under C.1. MSOE, to determine the privatization options[19] for 30 SOEs and 12 minority shareholdings.	February 2000		
7. For SOEs identified under C.1. MSOE, to achieve satisfactory progress in privatizing[20]: (i) at least 7 SOEs, and (ii) at least another 8 SOEs.		March 2003	March 2004
8. For minority shareholdings identified under C.1., MSOE to achieve satisfactory progress in completely selling shares in (i) at least 5 companies; (ii) another 7 companies.		March 2003	March 2004
D. Labor Redundancies			
1. MSOE to do the following: (i) Prepare a draft labor rationalization policy based on legal standards for severance and service payments as outlined in Presidential Decree 3/1996. (ii) Facilitate establishment of a consultative working group on labor rationalization. The group will expand the labor rationalization policy to include early retirement regulations, and assistance for redeployment (including training or retraining of workers, financing of entrepreneurial initiatives, and access to pension funds), unions, SOE management, and MSOE. Additionally, the group will hold seminars and workshops on labor legislation, and foster dialogue between labor unions, SOE management, and MSOE. Members will be selected from human resources managers in SOEs, Federation of SOE Labor Unions, Legal Aid Society, Ministry of Manpower (MOM), MSOE, and National Development Planning Agency (BAPPENAS). (iii) Approve recommendations of consultative working group.	April 2000 October 2001	June 2002	
2. MSOE will implement a labor rationalization program in accordance with the policy: (i) SOEs will lodge their labor restructuring plans, if any, (including costs implication) with MSOE and MOM to provide endorsement. (ii) MOM to record financial assistance being provided by Government to SOEs unable to meet the expenses for redundancies.		September 2002 ongoing	September 2003 ongoing
E. Procurement			
1. MSOE will require compliance by SOEs with transparent and fair procurement practices ensuring full accountability.	March 1999		
2. MSOE will: (i) Prepare TORs for the procurement auditors (ii) initiate random, independent (non- Financial and Development Supervisory Board) audits of the procurement by SOEs, present audit reports to steering committee and ADB, publish summary	April 2000		

[19] Privatization options include employee buy-out, strategic sale, free share transfer, IPO, joint venture, leasing of operating assets, granting of concessions, share arrangement, and cash auction

[20] For the purpose of this Program, privatization is defined as a reduction in the Government's share in the voting shares of a company (held directly or indirectly) to less than 50 percent.

Policy Actions	Action completed (1998 to Nov 2001)	Second Tranche Conditions July 2003	Third Tranche Condition July 2004
findings, and identify measures to recover losses and prosecute culprits: (a) for 20 SOEs, and (b) for another 20 SOEs.		**September 2002**	**September 2003**
3. Based on the results of random audits (see E. 2). MSOE will (i) develop guidelines for the procurement of SOEs, including requirement for compliance with environmental legislation in technical specifications of tender documents, differentiated by industry groups if necessary; (ii) introduce these new guidelines for necessary action; and (iii) assure that SOEs adopt guidelines or prepare adequate procurement procedures based on the guidelines.		September 2002 December 2002	March 2003

PROJECT FRAMEWORK

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Promote poverty reduction through sustainable pro-poor growth by (i) improving efficiency of resource allocation, (ii) increasing profitability in state-owned enterprise (SOE) sector, (iii) improving financial health SOEs, and (iv) raising revenues from privatizations for state budget.	Rise in real gross domestic product (GDP) growth underpinned with (i) increasing revenue of 117 SOEs (2000: Rp89.6 trillion), (ii) increasing operating profit (2000: Rp15.6 trillion), (iii) decreasing average debt-to-equity ratio (2000: 0.83), (iv) increasing dividend payments to state budget (2000: Rp3.5 trillion), and (v) generating revenues from privatizations of Rp6.0 trillion per annum (2002 to 2004).	• Reports from Ministry of State-Owned Enterprise (MSOE) on privatization revenues and number of deals. • Annual reports of SOEs to monitor improved operating profitability and financial indicators. • Review missions establishing profitability of SOEs.	• Economic recovery is delayed or reversed due to external circumstances. • Affected interest groups may slow or derail the reform and privatization program. • Risk perception because of current crisis can reduce offers from strategic investors unless a sound process is established. • Government's commitment to reform can weaken.
Purpose SOEGPP is designed to (i) improve resource allocation in the public sector, (ii) increase profitability of Indonesia's SOEs and (iii) promote private sector participation in all commercial activities of SOEs. By reforming SOEs and moving from ownership and management to selected regulation, the Government will release scarce resources, which could be allocated for poverty reduction, and stimulate the private sector to drive economic growth.	• Use (I) SOE dividends for development initiatives and social service expenses; and (ii) privatization revenues to pay the cost of bank restructuring. • Reduce the losses and improve the profits of SOEs through corporate governance, corporate restructuring, and liquidations (see items C.6. to C.12. in policy matrix of Appendix 1). • Implementation and execution of regulations for the commercialization of public service obligations (PSOs).	• Successive budgets throughout the duration of the SOEGPP to identify revenues in the form of dividends and privatization proceeds and expenditure for social safety net and poverty alleviation. • Annual reports, appointment agreements with commissioners and directors, statements of corporate intent (SCIs) of SOEs, reports from MSOE on the revenue from privatization.	• Success of corporate governance reform and restructuring of SOEs will increase willingness and political acceptability of privatization program. • Macroeconomic stabilization will continue during implementation period. • Cooperation from stakeholders and SOE management.
Outputs **1. Corporate Governance** a. Develop and introduce corporate governance policy framework for	The ministerial decree will include: • Appointment criteria, roles, responsibilities and accountability of boards of Commissioners (BOCs), and board of	• Steering committee review. • Asian Development Bank (ADB) oversight. • Working Group on Corporate	▪ Delays in consultations between MSOE and SOEs.

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
SOEs to empower the managers to create shareholder value under adequate supervision in a transparent environment promoting accountability.	directors (BODs) and templates for appointment agreements between the Government with the commissioners and directors;[1] • the objectives and scope SCI,[2] as a mechanism for implementation and enforcement of improved transparency and accountability standards; and • separate ministerial decree for a performance incentive system (PIS)[3] to reward management for improvements in defined performance indicators.	Governance reporting to the Steering Committee.	
b. Implement corporate governance policy.	Implement the following corporate governance measures covering 88 SOEs: (i) review and comment on the composition of the BOCs and BODs, including the numbers on the boards, and their skills mix and qualifications;[4] (i) negotiate and sign appointment agreements with commissioners and directors and SCIs (including reasonable PISs) for SOEs applying new corporate governance policy; and (iii) submit performance review reports (PRRs) on implementation of corporate governance policy (appointment agreements, SCIs, and PIS) covering SOEs with at least one year experience; PRRs should include key benefits of contracting system and suggested areas of improvement.	• Steering committee review. • ADB oversight. • SCIs submitted to MSOE.	• Delay in fielding consultants. • Delays in preparing SCIs. • Opposition from SOE commissioners and directors.
c. Improve transparency of SOEs.	• Create a new corporate secretary position for all SOEs to be listed. • All SOEs to file annual reports with the Company Registrar in line with existing regulations applying to listed companies.	• Steering committee review. • ADB oversight. • Consultant reports and confirmation from Company Registrar.	• Resistance from directors and commissioners • Lack of funds in MSOE to establish Internet site.

[1] These contractual arrangements can be documented in the minutes of the shareholder meeting.
[2] The SCI will be prepared by the BOD (company management), approved by the BOC, and submitted to MSOE.
[3] The PIS will form an integral part of SCIs and management contracts, linking management remuneration with achievement of performance targets outlined in the SCI, with due consideration for commercial, labor, and environmental legislation.
[4] To include a review of the role, obligations and composition of BOC and BOD to verify whether BOC has guided and monitored the implementation by BOD of (a) SOE's long-term plan (b) annual business plan and (c) budget.

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
	• MSOE to publish annual reports (including audited financial statements) of SOEs with majority Government ownership on a specially designed web page on the Internet. • Establish audit committees (including one commissioner and two outside experts) that should report directly to BOC.	• Steering committee reports, annual reports of SOEs.	
d. Capacity building for effective implementation of corporate governance mechanisms.	All MSOE deputy ministers, directors, and commissioners and directors of 88 SOEs to attend corporate governance workshops.	• Steering committee review. • Consultant reports.	• Lack of interest of directors and commissioners.
2. Public Service Obligations (PSOs)			
a. Quantify PSOs and develop regulations for their tender.	• Identify PSOs in selected 15 SOEs. • Quantify PSO costs and environmental impact. • Develop rules and regulations for tendering such services (allowing bidding by private companies) with the objective of minimizing subsidies.	• Consultant's reports.	• Delay in fielding consultants. • Opposition from line ministries. • Public opposition to changing delivery system for services.
b. Implement Policy	• Introduce the rules and regulations for tendering PSO, by private companies with the objective of minimizing subsidies. • Line ministries to contract[5] out the provision of selected public services to most competitive bidder, which may or may not be the SOE that had previously provided the services.	• Steering committee review. • ADB oversight. • PSO contracts. • Consultant reports	• Government can not allocate funds for transparent subsidization of PSOs. • Prolonged negotiation about pricing of PSOs.
3. Corporate and financial restructuring of SOEs in preparation for eventual privatization			
a. Liquidation of non-viable SOEs.	• Identify nonviable SOEs and SOE business lines to be discontinued. • Liquidate 4 nonviable SOEs.	• Steering committee review. • ADB oversight	• Delay in MSOE decision. • Opposition/protest from nonviable SOEs and their employees.
b. Financial Restructuring of SOEs	• MSOE to implement corporate restructuring plans[6] for 30 SOEs identified, with appropriate consideration for all relevant	• Steering committee review. • ADB oversight	• Delay in negotiations with banks and other lenders, Indonesia Bank Restructuring

[5] The contracting process (i.e., open tender) should give due consideration to compliance with environmental legislation in technical specifications.

[6] Corporate Restructuring includes financial and/or operational restructuring. Financial restructuring could take one or more of the following options: (i) selling subsidiaries and/or surplus assets, (ii) equity injection from third parties, (iii) mergers or acquisitions of SOEs by SOEs, (iv) debt restructuring, and (v) liquidation. Operational restructuring could involve changes to one or more of the following: (I) management information systems, (ii) production and logistics planning, (iii) distribution network, (iv) marketing strategy, (v) workforce number and composition, and (vi) organizational structure.

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
	legislation and policies stipulated under this program.		Agency (IBRA), or Jakarta Initiative Task Force (JITF). • Disagreement between the Steering Committee and Consultants
c. Improve quality of financial audits. d. Privatize SOEs	• Complete independent (non-Financial and Development Supervisory Board), three-year financial audit for 78 SOEs that should include remuneration and all expenses (direct as well as fringe benefits) of the BOC and BOD members. • Determine the privatization options[7] for 30 SOEs and 12 minority shareholdings. • Issue initial public offerings (IPOs) for 12 SOEs. • Privatize 15 SOEs. • Sell minority shareholding in 12 companies	• Steering committee review • ADB oversight. • Audit reports. • Steering committee review. • ADB oversight.	• Disagreement between MSOE and SOEs on selection for audit. • Delay due to unfavorable market condition for floatation/finding investment partner • Disagreement about valuation of SOEs between the Government and strategic investors.
4. Establishing Fair and Transparent Procedures for Managing Labor Redundancies			
Development of labor redundancy policy for all SOEs.	• MSOE to prepare a draft labor rationalization policy. • MSOE to facilitate establishment of a consultative working group on labor rationalization. The group will expand the labor rationalization policy and foster dialogue between labor unions, SOE management, and MSOE. ▪ SOEs to lodge their labor restructuring plans, if any, (including cost implications), with MSOE, and Ministry of Manpower (MOM) to provide endorsement. ▪ MOM to record financial assistance being provided by Government to SOEs unable to meet the expenses for redundancies.	• Steering Committee review. • ADB oversight. • MSOE reports. • MOM reports.	• Lack of cooperative attitude of working group members. • Opposition from labor union/workforce. • Government can not allocate sufficient funds for redundancy payments in lieu of SOEs.

[7] Privatization options include: employee buy-out, strategic sale, free share transfer, initial public offering, joint venture, leasing of operating assets, granting of concessions, golden share arrangement, and cash auction

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
5. SOE Procurement			
Reduction of corruption in SOE procurement.	• Initiate random, independent, or BPKP audits of the procurement by SOEs, and present audit reports to steering committee and ADB. • Publish summary findings and identify measures to recover losses and prosecute culprits	• Steering committee review. • ADB oversight. • Procurement guideline for SOEs.	• Opposition to the implementation of guidelines from SOEs.

COVERAGE AND IMPLEMENTATION SCHEDULE OF THE PROPOSED PROGRAM AND RELATED TECHNICAL ASSISTANCE

(subject to regular review by MSOE)

	Number of Employees 2000	Assets (bn Rp) 2000	Industry	Previous TA-3149[a]	New TA-3714[b]	New TA-3728[c]	Sale Of Shares[d]	Financial Audit in 2002	Financial Audit in 2003	Procurement[e] Audit 2002	Procurement[e] Audit 2003	Application of Corp. Gov. Policy 2002[f]	Application of Corp. Gov. Policy 2003
1. Primary Industries													
PT Perikana Besar	566	30,9	Fishing										
PT Perikani	285	9.0	Fishing										
PT Usaha Mina	1,433	56.4	Fishing	Report			SS						
PT Tirta Raya Mina	148	10.4	Fishing										
PT Inkutani I	2,160	706.7	Forestry			Restr.							
PT Inkutani II	1,428	344.5	Forestry			Restr.							
PT Inkutani III	2,349	386.2	Forestry			Restr.							
PT Inkutani IV	575	140.5	Forestry			Restr.							
PT Inkutani V	530	248.6	Forestry			Restr.							
PT Aneka Tambang	4,708	2390.7	Mining	Report			JSE						
PT Tambang Timah	5,439	1419.7	Mining	Report			JSE					Pilot	
PT Tambang Batubara	4,492	1,608.3	Mining	Report			IPO						
PT Sarana Karya	291	12,132.0	Asphalt	Report	Liqu.		SS						
PTPN I	8,907	455.5	Plantations										
PTPN II	26,829	1,044.6	Plantations										
PTPN III	31,582	1,287.1	Plantations				SS						
PTPN IV	44,523	1,700.4	Plantations				SS						
PTPN V	16,409	952.5	Plantations										
PTPN VI	8,927	390,8	Plantations										
PTPN VII	33,927	850.0	Plantations				SS						
PTPN VIII	32,855	846.2	Plantations	Report			SS						
PTPN IX	15,366	429.0	Plantations	Report	Restr.		SS						
PTPN X	14,764	657.6	Plantations										
PTPN XI	21,469	712.4	Plantations										
PTPN XII	61,022	484.0	Plantations	Report	Restr.		SS						
PTPN XIII	13,916	786.4	Plantations										
PTPN XIV	6,625	403.9	Plantations										
PT Pertani	1,228	257.2	Agri Inputs										
PT Sang Hyang Seri	869	126.6	Seeds									Pilot	
Subtotal	345,302	13,667.5											
Percent of Total	51.0%	9.2%											

shaded cells = SOEs covered by program components.

[a] TA 3149-INO:*Corporate Governance and Enterprise Restructuring*, for $2.47 million, approved on 28 December 1998. Report: Company report received from consultants.

[b] TA 3714-INO: *Privatization and Restructuring of SOEs.* for $2.6 million, approved on 5 September 2001. Restr.: Corporate Restructuring. Debt: Debt Restructuring. Liqu.: Analysis for Liquidation.

[c] TA 3728-INO: *Commercialization of Public Service Obligations*, for $1.25 million, approved on 25 September 2001. Restr.: Corporate Restructuring with PSO separation.

[d] SS = strategic sale; JSE = secondary offering on Jakarta Stock Exchange; IPO = Initial Public Offering; E/MBO: employee/management buy-out; 34 SOEs are highlighted, of which 10 will be privatized under the Program.

[e] In 40 randomly selected SOEs.

[f] Pilot = Statement of Corporate Intent has been finalized under TA 3149.

	Number of Employees 2000	Assets (bn Rp) 2000	Industry	Previous TA-3149	New TA-3714	New TA-3728	Sale of Shares	Financial[g] Audit in 2002	Audit in 2003	Procurement Audit 2002	Audit 2003	Application of new Corp. Govern. Policy 2002	2003
2. Manufacturing													
PT IPTN	0	0	Aircraft		Debt			IBRA	IBRA				
PT Semen Gresik	6,734	7,372.2	Cement				JSE						
PT Semen Baturaja	807	550.5	Cement	Report	Debt		SS	IBRA	IBRA				
PT Semen Kupang	252	272.2	Cement										
PT Industri Soda	260	30.4	Chlorine Chem	Report	Liqu.								
PT LEN Industri	637	110.0	Electronics									Pilot	
PT Dahana	279	161.0	Explosives										
PT Pupuk Srivijaya	15,207	10,002.1	Fertilizers	Report									
PT Pupuk Kaltim			Fertilizers	Report			IPO						
PT Pupuk Iskandar			Fertilizers	Report	Restr.								
PT Aceh Fertilizer	789	1,095.9	Fertilizers	Report									
PT Petrokimia Gresik			Fertilizers	Report	Restr.								
PT Pupuk Kujang			Fertilizers	Report	Restr.								
PT Industri Gelas	1,126	287.3	Glas Bottles		Restr.		SS						
PT INKA	1,689	225.7	Locomotives										
PT Boma Bisma Indra	2,041	220.0	Machinery										
PT Barata Indonesia	2,799	190.6	Machinery	Report	Liqu.								
PT Kertas Kraft Aceh	1,134	668.1	Paper										
PT Bio Farma	671	222.7	Pharma	Report		Restr.	SS						
PT Indo Farma	1,758	500.1	Pharma	Report			SS						
PT Kimia Farma	5,121	767.7	Pharma				SS						
PT Kertas Leces	3,148	1,090.2	Pulp & Paper		Debt			IBRA	IBRA				
PT Garama	548	240.6	Salt	Report			SS/MBO						
PT PAL Indonesia	3,910	2,290.6	Shipbuilding										
PT Dok & Perk. Kadja	2,643	1,622.4	Shipbuilding	Report	Liqu.		SS	IBRA	IBRA				
PT Industri Kapai	515	162.0	Shipbuilding	Report	Liqu.								
PT Dok & Perk. Surabaya	810	72.2	Shipbuilding	Report			SS						
PT Krakatau Steel	6,288	7,444.0	Steel Mill				IPO						
PT INTI	1,811	1,004.6	Electronics										
PT Industri Sadang	6,826	436,0	Textiles	Report			SS						
PT Cambrics Primissima	1,184	89.0	Textiles	Report			SS						
Subtotal	85,776	30,551.8											
Percent of Total	12.7%	20.7%											

g IBRA = Indonesian Bank Restructuring Agency.

	Number of Employees 2000	Assets (bn Rp) 2000	Industry	Previous TA-3149	New TA-3714	New TA-3728	Sale[h] of Shares	Financial Audit in 2002	Audit in 2003	Procurement Audit 2002	Audit 2003	Application of new Corp. Govern. Policy 2002	2003
3. Construction Companies													
PT Pengerukan	0	0	Dredging										
PT Adhi Karya	1,429	1,011.3	Construction		Debt								
PT Pembangunan	399	629.2	Construction		Debt			IBRA	IBRA				
PT Wijaya Karya	771	757.8	Construction	Report									
PT Hutama Karya	1,954	1,013.9	Construction	Report	Debt		SS	IBRA	IBRA				
PT Waskita Karya	1,150	395.2	Construction										
PT Nindya Karya	408	290.8	Construction	Report	Debt		SS	IBRA	IBRA				
PT Istaka Karya	212	836.4	Construction	Report	Liqu.								
PT Amarta Karya	235	68.9	Construction										
PT Brantas Abripaya	288	103.7	Construction										
Subtotal	9,843	5,103.8											
Percent of Total	1.5%	3.5%											
4.Trading Companies													
PT Dharma Niaga	901	703.7	Trading		Debt			IBRA	IBRA				
PT Pantja Niaga	859	121.5	Trading										
PT Cipta Niaga	1,398	212.2	Trading	Report	Debt		SS						
PT Banda Glara Reksa	1,228	59.9	Trading									Pilot	
PT Sarinah	1,019	70.8	Trading	Report			SS						
Subtotal	6,524	1,408.3											
Percent of Total	1.0%	1.0%											
5. Utilities and Infrastructure													
PT Telkom	2,567	29,206.3	Telecommuncation				JSE						
PT Indosat	19,040	6,330.9	Satellite Comm.				JSE						
PT Pelindo I	1,435	943.9	Seaport			Restr.	SS						
PT Pelindo II	3,433	3,938.6	Seaport			Restr.	JV						
PT Pelindo III	3,329	1,611.5	Seaport			Restr.	JV					Pilot	
PT Pelindo IV	1,481	683.8	Seaport			Restr.	SS						
PT Angkasa Pura I	4,570	2,571.2	Airport			Restr.	JV/JSE						
PT Angkasa Pura II	5,289	3,169.2	Airport			Restr.	JV/JSE						
PT Jasa Marga	6,408	3,236.3	Toll Roads	Report			SS						
PT PLN	53,270	238,214.1	Electricity									Pilot	
PT PGN	1,333	2,883.9	Gas	Report									
PT Pos Indonesia	26,555	1,917.6	Postal Services										
Subtotal	150,713	85,280.8											
Percent of Total	22.2%	57.6%											

[h] JV = joint venture.

	Number of Employees 2000	Assets (bn Rp) 2000	Industry	Previous TA-3149	New TA-3714	New TA-3728	Sale of Shares	Financial Audit in 2002	Financial Audit in 2003	Procurement Audit 2002	Procurement Audit 2003	Application of new Corp. Govern. Policy 2002	Application of new Corp. Govern. Policy 2003
6. Service Industries													
PT Pradnya Paramita	39	5.9	Publishing	Report	Liqu.								
PT Varuna T. Prakarya	396	51.5	Freight Forwarder	Report			E/MBO						
PT Pelayaran Bahtera	335	76.8	Transport	Report									
PT SurveyUdara Penas	98	11.6	Survey & Mapping										
PT RNI	20,895	2,204.8	Conglomerate					IBRA	IBRA				
PT Garuda Indonesia	9,560	8,577.3	Airline		Restr.								
PT Merpati Nusantara	4,490	791.2	Airline			Restr.							
PT P.D.I. Pulau Batam	450	39.2	Property Mgmt.	Report			SS						
PT Kaw. B. Nusantara	659	341.8	Property Mgmt.									Pilot	
PT Kaw. Ind. Makasar	37	26.3	Property Mgmt.										
PT Kaw. Industri Medan	143	102.4	Property Mgmt.	Report									
PT Pengembangan…Bali	275	141.5	Property Develop.	Report									
PT PELNI	6,323	3,770.7	Shipping			Restr.							
PT Djakarta Lloyd	1,177	736.0	Ocean Shipping	Report	Liqu.								
PT Angkutan Sungai	3,084	342.9	Shipping			Restr.						Pilot	
PT Indah Karya	347	16.1	Consulting										
PT Indra Karya	557	18.3	Consulting										
PT Virama Karya	818	16.7	Consulting										
PT Yodya Karya	597	18.2	Consulting										
PT Bina Karya	519	23.5	Consulting	Report									
PT Konservasi Energi	52	10.0	Consulting										
PT Hotel Indonesia Natur	5,045	207.4	Hotels	Report			SS	IBRA	IBRA				
PT Surveyor Indonesia	507	225.9	Surveying					IBRA	IBRA				
PT Sucofindo	4,316	662.6	Surveying				SS						
PT Biro Klassifikasi	310	29.6	Certification										
PT Perhotelan	3	14.4	None	Report	Liqu.								
Subtotal	78,640	11,906.1											
Percent of Total	11.6%	8.0%											
Total, 113 SOEs	**676,798**	**147,918.3**											

	Number of Employees 2000	Assets (bn Rp) 2000	Industry	Previous TA-3149	New TA-3714	New TA-3728	Sale of Shares	Financial Audit in 2002	Financial Audit in 2003	Procurement Audit 2002	Procurement Audit 2003	Application of new Corp. Govern. Policy 2002	Application of new Corp. Govern. Policy 2003
7. Companies not to be privatized before 2005													
PT Batan Teknologi	101	32.1	Nuclear Fuel										
PT Pakarya Industri	30,640	14,620.3	Holding Company	Report	Liqu.								
PT TWC Borubudor	371	86.4	Conservation										
PT Pindad	4,674	453.0	Ammunition Manuf.										
		Holding %	**Industry**	**TA 3149-INO**									
8. Minority Shareholdings													
PT Inalum		41.1%	Aluminium Smelter	Report									
PT Indosemen		26.0%	Cement	Report	Combined sale with IBRA assets possible								
PT Jakarta Intern. Hotel		3.3%	Hotel		Sale to majority shareholder								
PT Wisma Nusantra Intern.		42.0%	Hotel	Report	Sale to majority shareholder								
PT Askrindo		45.0%	Insurance		Under MOF								
PT Reasuransi Umum		?	Insurance		Under MOF								
PT Bank Bukopin		22.2%	Micro Finance Bank	Report	Sale to majority shareholder								
PT Bahana Pembinaan		30.0%	Financial Services	Report	Sale to majority shareholder								
PT Kertas Blabak		1.6%	Paper		Free transfer to employees								
PT Kertas Basuki		0.2%	Paper	Report	Free transfer to employees								
PT Kertas Padalarang		40.0%	Security Paper	Report	Sale to majority shareholder								
PT Asean Bintulu Fertilizer		13.0%	Fertilizer		Other shareholders are ASEAN governments								
PT Asean Copper Products		13.0%	Copper Processing		Other shareholders are ASEAN governments								
PT Atmindo		30.0%	Heavy Equipment	Report	Sale to majority shareholder								
PT Freeport Indonesia		9.8%	Gold Mining		Sale to majority shareholder								
PT Intirub		16.0%	Tyres	Report	Sale to majority shareholder								
PT Prasada		5.0%	Waste Water	Report	Sale to majority shareholder								
PT JIEP		50%											
PT SIER		50%											
PT Rekayasa Industri		5.0%	Consulting										
PT Socfindo		40%	Plantation										
PT PG Madu Baru		25.0%	Sugar	Report			IPO						

POVERTY IMPACT ASSESSMENT

1. The State-Owned Enterprise Governance and Privatization Program (SOEGPP) makes a positive contribution to the poverty reduction objective of the Asian Development Bank (ADB) in Indonesia through (i) removing market distorting interventions to stimulate growth, and (ii) improving the quality of governance in a critical area of the public-private sector interface.

2. The quality of governance is critical to poverty reduction.[1] Since effective and efficient delivery of basic services by the public sector matters most to the poor, weak governance hurts them disproportionately. Public sector inefficiency, corruption, and waste have left the Government with insufficient resources to support the requisite level and quality of public services and targeted antipoverty programs. The SOEGPP will support the establishment of good governance, giving a role model for both public and private sectors, which, if followed, will facilitate participatory, pro-poor policies, as well as sound macroeconomic management. SOEGPP will advance the transparent use of public funds, encourage sound fiscal management, promote efficient delivery of public services, and help establish the rule of law.

3. Privatization as supported by the SOEGPP will improve productive and allocative efficiency. Therefore, prices of goods and services produced by the privatized enterprises should decline and their quality should improve. While SOEs have been heavily subsidized in the past, most of the subsidies have been abolished or are in the process of being abolished. Privatization will only occur after the enterprises have been placed into a competitive environment. By removing economic distortions in the competitive environment first, the Government increases the probability that higher productivity and allocative efficiency will be achieved.

4. Privatization affects income distribution through three channels. The first channel is the shift of real assets from the state to the private sector, with consequences for the distribution of capital income. If the price paid for the asset is close to the discounted present value of the future income stream, no negative distributive impact will arise. The problem arises where assets are sold at a price below value, particularly if due to corruption. To address this, SOEGPP will establish sales procedures establishing maximum transparency, and support the privatization by providing privatization experts through TAs. The second channel is labor income, which should generally increase over time for those retained in their job. The third channel is wage differentials, which are typically wider in the private than in the public sector, and privatization will tend to reinforce them. However, the decompression of pay scales can be expected to be phased in slowly over time.

5. SOEs are not a major source of employment. In total, the SOEs employ about 700,000 people directly and another 700,000 indirectly through contract and subcontract labor arrangements. This is less than 1.5 percent of the overall labor force[2] and 4.5 percent of the formal labor force.[3] Furthermore, wages and benefits paid by the SOEs are not significantly different from those paid by the private sector for the most vulnerable category of worker, those below the supervisor level. Unlike some formerly centrally planned economies, the SOEs were

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[1] Compare *ADB, Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank, Manila*, page 8, 19 October.

[2] As of August 1999, this was 94 million people, and defined as those 15 years or older who were working, were temporarily absent from work, or who didn't have work but were looking for work. "Working" is an activity done for pay or to assist others in obtaining pay or profit for the duration of at least one hour during the survey week.

[3] The formal labor force is defined as comprising employers and employees, and excludes the self-employed and unpaid family workers.

not a major source of employment and they did not provide a large range of social services.[4] Nonetheless, treatment of labor by the SOEs sets an important standard of behavior for private sector enterprises.

6. SOEs have about 10-20 percent surplus employment, or 70,000-140,000 people, with 20 percent considered an outside maximum and 10 percent representing the more reasonable estimate. As national open unemployment was estimated as 6,030,000 in August 1999, overnight layoffs would not result in an appreciable increase in overall numbers although the impact could be significant at a local level. Surplus managerial staff exists where firms have undergone mergers such as in the plantation industry as well as below the supervisor level where changes in technology have reduced the need for low skill labor and necessitate a different skill mix. For this reason, most layoffs are likely to occur at lower levels and therefore will affect people who will then be less likely to find equivalent employment in the formal sector. Legally mandated severance standards are considered inadequate by labor representatives. Negotiated settlements tend to exceed the minimum standards. Compared to the private sector, SOE employees are at a disadvantage in such negotiations as prior to 1999 they were not allowed to unionize or engage in collective bargaining. As a result they have little practical experience in negotiating their interest with management. Conversely management has had little experience in dialogue with labor in employment and employment related issues.

7. For this reason, SOEGPP puts a strong emphasis on establishing a consultative working group on labor relations, with representatives of all stakeholders to develop a labor rationalization policy within the Ministry of State-Owned Enterprises (MSOE). The consultative working group is expected to develop standards for negotiating settlements, to serve as a conduit for information for labor representatives, and provide a forum for policy discussion regarding unresolved labor issues such as the treatment of contract labor. Once approved by the Board of Directors of the Asian Development Bank (ADB), this report will be available to the public and will provide information to labor representatives and advocates regarding the Government's intentions and schedule for corporate restructuring and privatization. Thus, the SOEGPP will provide a channel for workers and their representatives to participate more fully and in an informed way in a dialogue to ensure their best interest.

8. The poverty impact assessment matrixes are presented below, with a more detailed discussion of the individual conditionalities of the SOEGPP.

A. Policy Area A: Corporate Governance

9. These measures will result in (i) the implementation of new corporate governance policies and procedures for MSOE and boards of commissioners and directors, (ii) an independent financial and management audit of all SOEs, (iii) a review of commissioners and directors for more than half of all SOEs, and (iv) implementation of performance incentive systems for management and employees. These measures will also introduce sound corporate governance practices to empower and encourage managers to act in the best interest of their shareholders, the people of Indonesia. Implementation of the statements of corporate intent will require SOEs to report compliance on a number of regulations, including those regarding employment. Overall, these measures will result in better management and fairer treatment of

[4] Certain industries that developed in remote areas such as in the plantation and mining sector provided access to social services, clinics, and schools. Prior to the crisis, such services were being rationalized. Other benefits were limited to specific categories of employees. Until recently in the plantation sector only employees in positions designated as staff were entitled to a pension.

labor and ultimately greater efficiency and returns to public investment, growth, and poverty reduction. Table A4.1 summarizes these measures and their impact.

Table A4.1 Effects of Improved Corporate Governance

Channel	Direct	Indirect	Macro	Non-Poor
Labor			Greater demand for goods and services produced by the poor (assumption 1)	
Access for Poor				
Prices				
Transfers			Greater public revenues for poverty reduction programs (assumption 2)	
Crucial Assumptions	1. Higher returns on investment stimulates growth and economic expansion 2. More efficient SOEs will generate more taxable income and, hence, more public revenues for development expenditures.			
Net Impact	Positive			
Narrative	These measures contribute to poverty reduction through overall growth and increased government revenues for expenditure on human resource development and poverty reduction programs.			

SOE = state-owned enterprise.

B. Policy Area B: Commercialization of Public Service Obligations

10. The SOEs are responsible for ensuring the provision of public goods and services necessary for national development purposes but have done so at high cost. At the same time, the assignment of monopoly rights and protectionism has stifled the development of a competitive private sector. Cross-subsidy between profitable and unprofitable operations within a company mask inefficiencies of operation and fails to promote the efficient provision of quality services. As a result of protectionist policies and poor management, Indonesian consumers pay higher prices for a range of essential commodities, including drugs and pesticides. The efforts to provide subsidies to particular sectors have resulted in market distortions, capture of subsidies by unintended groups including the producers themselves, and a poor return to national investment. If subsidies cannot be abolished for political reasons, their true cost should be explicit and the subsidy delivered in an efficient and targeted fashion.

11. The measures promoted under the program identify the types of SOE public service obligations and establish mechanisms for efficient provision by the private sector or continued provision by SOEs with clear identification of costs and intended levels of subsidies. Regulated and private provision of public service obligations or continued SOE provision with the establishment of clear cost centers and subsidy mechanisms will reduce the distorting impact of these obligations on SOE operations while promoting low cost and efficient provision of services. Table A4.2 summarizes the effects of commercializing public service obligations.

Table A4.2: Effects of Commercializing Public Service Obligations

Channel	Direct	Indirect	Macro	Non-Poor
Access for Poor		Will improve as PSO will be more efficiently produced	More access to public goods and services	More access to public goods and services
Crucial Assumptions	Lower cost and more efficient delivery of public goods and services allows for greater provision at the same cost.			
Net Impact	Positive			
Narrative	These measures will encourage efficient provision of public goods and services to benefit poor and non-poor.			

PSO = public service obligations.

C. Policy Area C: Corporate Restructuring

12. These measures develop guidelines, procedures, and a timetable for privatization for commercially viable SOEs. This will provide the MSOE with an operational procedure for implementing privatization. To reduce the drain on the budget, criteria and procedures are agreed upon for liquidating nonviable SOEs. To obtain the best price for SOEs slated for privatization, their profitability and potential is demonstrated through the implementation of performance targets as set out in the statements of corporate intent (SCIs) (see policy area A). The privatization process is accelerated through the selection of the best privatization options of SOEs requiring limited restructuring and reduction of the shareholding of SOEs where the Government has decided to retain some interest. Table A4.3 summarizes the effects of restructuring SOEs.

Table A4.3: Effects of Corporate Restructuring

Channel	Direct	Indirect	Macro	Non-Poor
Transfers			Increased government revenue for development expenditures	
Net Impact	Positive			
Narrative	These measures are necessary to enable the Government to obtain the best return from the divestiture of commercially viable SOEs and reduce the drain on the national budget from the support of non viable SOEs.			

SOE = state-owned enterprises.

D. Policy Area D: Labor Redundancies

13. The level of skill and the education profile of the SOE labor force is higher than that of the formal labor force where 44 percent of the labor force has no more than an elementary school education. The plantation sector, accounting for 50 percent of the labor force, is a significant exception to this. In the remaining SOEs, the proportion of low skill labor is very low due to the generally higher skill requirement of the production process as well as the practice of outsourcing unskilled and casual work. Low skill labor for casual work, stevedoring, landscaping, and general cleaning services are obtained through service contracts with private firms. As a result, outside of the plantation sector, SOE employees tend to be more educated than the general labor force.

14. As with the private sector, the SOE labor force tends to be segregated by gender with women clustered in occupations at the low end of the pay scale. In the plantations they tend nurseries, carry out maintenance, spread fertilizer, harvest cacao and tea, tap rubber, or work as clerics. They are seldom in supervisory positions. Outside of the plantations women tend to be found in SOEs that require a high degree of customer service such as toll collection or cabin flight assistance.

1. Staffing issues

15. The degree to which staffing levels, staff qualifications, and staff management are an issue varies significantly from company to company. Part of the overstaffing problem has arisen from the slowdown in demand and is to some extent self correcting. Some SOEs provide a knowledge-based product (chemicals, semiconductors) with a large investment in staff training. It is in the interest of such firms to retain their employees during a downturn. Some SOEs are overstaffed at management levels as a result of merger and consolidation. The present plantation and forestry SOEs are the result of the consolidation of smaller plantations and related downstream business units. PTP Nusantara IV is the result of a merger of 25 separate business units and consolidation has resulted in significant duplication of administrative staff and management staff.

2. Labor Relations

16. Labor relations are in a state of change following the introduction of a new labor law that enabled free association and the establishment of new unions in keeping with International Labor Organization (ILO) convention 87. This law came into force in June 1999. Previously, SOE employees were considered quasi-civil servants. SOE employees were obligatory members of Korpri (Corps of Civil Servants) and were not allowed to become labor union members. SOE employee participation in Korpri became discretionary in November 1998, after which SOE employees could join labor unions and enter into collective labor agreements. Establishment of plant-level unions within the SOEs has been initiated with MSOE's blessing, although the role of these unions is curtailed by their relative lack of experience. In addition SOE employees and contract workers have begun to join the established labor unions. Various efforts are under way to promote understanding of the role and function of unions among workers and management. The Ministry of Manpower, with ILO assistance, has been training unions in how to function in both private and public sector organizations and promoting understanding of labor unions and collective bargaining for personnel management. The labor federations such as SPSI (All Indonesian Worker's Union), SPSI-R (All-Indonesian Workers Union-Reformation), and SBSI (Indonesia Prosperous Worker's Union) have been carrying out their own outreach efforts. While considerable work remains to develop mature labor unions, these organizations agree that their own efforts will be facilitated by a policy dialogue promoting open discussion of labor issues and by access to information regarding labor practices and plans for restructuring and privatization. The establishment of a consultative working group on labor rationalization will enable such policy and access.

3. Labor Protection Issues

17. Labor protection issues that are likely to arise as a result of a retrenchment process include entitlement to employer's contributions with pension fund, unfunded liabilities, payout for SOEs with insufficient funds, and provisions for subcontracted labor. Support may be required to fulfill pension obligations for early retirement pay. While many SOEs are establishing or have established fully funded pension funds in conformity with new Ministry of Finance regulations, some have not been able to meet the funding requirements and continue to hold their pensions in pension foundations. Other SOEs pay pensions out of operating expenses. Employer contributions match or exceed employee pension contributions. While most pension schemes have provisions for early retirement, few have provisions for retrenchment. Clarification must be sought from the Ministry of Finance regarding entitlement to employer contributions. Measures will be required to avoid imposing an undue burden on pension funds that have invested in long-

term instruments and may find a large and unscheduled pay-out requirement difficult to meet. Funding will be required for firms unable to meet severance payment obligations. In some cases, additional provisions will be required for subcontracted labor.

4. Current Experience with Retrenchment

18. While SOE restructuring was under way on a limited scale prior to the crisis, the need for restructuring has intensified. However there has been little experience with large scale retrenchment. As a consequence, few company regulations, pension funds, or labor agreements have provisions for retrenchment.

19. The experience to date has been mixed. The national aircraft manufacturer (IPTN) had a relatively smooth retrenchment process beginning with benchmarking and dissemination of benchmarking results, then discussion and debate among employees, culminating in the formulation of a formal employee recommendation for a retrenchment plan, procedures, and level of compensation for consideration by management. The plan gave several scenarios of which one was adopted. The program was announced and a center established where workers could calculate what they would get if they accepted the voluntary retrenchment and early retirement scheme. Programs were run for families of employees and the spouse had to agree for the application to be accepted. The first wave targeted all employees with only elementary and junior high education. The second wave targeted employees from vocational junior and senior high schools. By the time of the ADB mission appraisal, 2,500 employees had been retrenched through this process and a third selection wave was under way. PT Wijaya Karya had undergone a 15 percent reduction in the workforce. This was facilitated by the provision for retrenchment in all employment agreements and a system for regular personnel review and assessment. Retrenched employees were provided counseling. Some outplacement assistance and some lower level employees were provided skills training. The 40 private banks unilaterally established a package of compensation for workers, which was not accepted, and this has led to acrimonious and protracted discussion. The Indonesian Bank Restructuring Agency finally reached an agreement with retrenched employees of banks after 18 months of protracted negotiations.

20. The current best practices indicate the difficulty in developing rules of thumb in terms of months of pay that would constitute fair practice. Industry characteristics, state of the labor market, skill level of the employee, and length of tenure are variables to be considered. The ultimate measure of an effective arrangement is worker and management satisfaction with the agreement. This is reached through a process involving the provision of information followed by consultations and then negotiations.

21. The measures under this part of the Program support strengthening the system for social protection in Indonesia. Existing legal standards are generally agreed to be adequate. However, they can only regulate minimum standards as it is difficult to develop standards that are adequate to cover the full range of skills, experience, and labor market segments in which they are to be applied. ADB, through its technical assistance, will have a significant role in assisting MSOE to develop policies for a retrenchment process based on the best practices evolving within the SOEs and from international example. This will help ensure that workers receive an equitable compensation package and to resolve issues regarding entitlement to employer's contributions to pension funds, unfunded liabilities, payouts for SOEs with insufficient funds, potential burden on pension funds, and any issues that may arise from excessive use of contract labor.

Table A4.4: Effects of Retrenchment Mitigation

Channel	Non-Poor
Labor	▪ Strengthens labor protection by promoting best practices in retrenchment.(1) ▪ Ensures that retrenched workers are able to obtain the agreed payouts and benefits due. (2)
Crucial Assumptions	(1) Establishment of procedures and process for retrenchment that provide information, communication, and negotiations through the Consultative Working Group (2) Resolution of issues regarding entitlement to employer contribution to pension funds, unfunded liabilities, payouts for SOEs with insufficient funds, and potential burden on pension funds.
Net Impact	Positive
Narrative	The benefits of these measures to strengthen labor protection practices goes beyond the program to benefit workers in the private sector. This

E. Policy Area E: Procurement

22. Policy measures for SOE procurement will further contribute to the benefits of policy area A to promote better management, greater efficiency, and returns to public investment, growth, and poverty reduction.

MATRIX OF POTENTIAL ENVIRONMENT IMPACTS OF POLICY COVENANTS

Policy Actions[1]	Likely Potential Environmental Impact (+): Positive (-): Negative
A. Corporate Governance 1. For state-owned enterprises (SOEs) not listed on a stock exchange, develop and strengthen corporate governance policy framework for SOEs to empower the managers to create shareholder value under adequate supervision in a transparent environment promoting accountability. Introduce for SOEs a new corporate governance policy that will mandate: (i) appointment criteria, roles, responsibilities and accountability of boards of commissioners (BOCs), and boards of directors (BODs) and templates for appointment agreements between the Government as shareholder through the general meeting of shareholders with the commissioners; templates for appointment agreements between the Government as shareholder through the general meeting of shareholders with the directors;[2]	(+): In general, improved corporate governance will improve environmental management, so long as governance is defined as including adherence to all relevant regulatory requirements, including environmental performance standards. Neutral
(ii) the objectives and scope of the statement of corporate of intent (SCI),[3] as a mechanism for implementation and enforcement of improved transparency and accountability standards: SCI will set out the objectives and scope of the SOE’s activities, and define the business plan (including all corporate restructuring measures), accounting policies, performance targets, disclosure requirements, compliance with environmental legislation,[4] status of employees and compliance with laws and regulations regarding labor relations, and procedures to be followed before subscribing for, purchasing, or acquiring shares in organizations; and (iii) a performance incentive system (PIS)[5] to reward management for improvements in defined performance indicators.	(+): compliance with environmental regulation will reduce adverse environmental impacts. (+): impacts will be positive so long as defined performance indicators include environmental performance standards.

[1] Dates in bold are conditions for the release of the second and third tranches.
[2] These contractual arrangements must be documented in the minutes of the shareholder meeting.
[3] The SCI will be prepared by the BOD (company management), approved by the BOC, and submitted to MSOE.
[4] Where appropriate, this will be confirmed through appropriate certification (e.g., ISO 14000) by an accredited agency.
[5] The PIS will form an integral part of both SCIs and management contracts, linking management remuneration with achievement of performance targets outlined in the SCI, with due consideration for commercial, labor, and environmental legislation.

Policy Actions	Likely Potential Environmental Impact (+): Positive (-): Negative
2. Implement corporate governance policy through (i) review and comments on the composition of the BOC and BOD, including the numbers, skills mix, and qualifications;[6] (ii) negotiate and sign appointment agreements for all newly appointed directors and commissioners; (iii) implement a performance incentive system to reward managers for improvements in defined performance indicators, by issuing a ministerial decree; (iv) prepare SCIs for[7] (a) first group of 3 SOEs, (b) second group of 35 SOEs, and (c) third group of 50 SOEs; and (v) submit a performance review report on the implementation of the corporate governance policy (appointment agreements, SCIs, and PISs) covering SOEs with at least one year experience: the report should include key benefits of the contracting system and suggested areas of improvement.	(+): In general, professional managers are likely to be more cognizant /mindful of legal requirements of environmental regulation. This will be strengthened if performance incentive systems apply the new corporate governance policy, including environmental performance.
3. Ensure all listed SOEs are fully complying with the listing rules of the Jakarta Stock Exchange in particular with the following provisions on corporate governance: (i) appointment of independent commissioners in proportion to the number of shares held by noncontrolling shareholders; (ii) establishment of an audit committee comprising at least three members, one of whom is an independent commissioner and the others independent professionals in accounting and/or finance recruited from outside the company; and (iii) appointment of a corporate secretary, who is a BOD member or a corporate officer specifically appointed to this function.	(+): As for A 1 (iii).
4. Improve transparency of SOEs. (i) Create a new corporate secretary position for all SOEs to be listed during next 12 months. The secretary is to be appointed within four months of the expected listing date of the SOE, and will be responsible for corporate communications. (ii) The Ministry for State-Owned Enterprises (MSOE) to require that all SOEs prepare an annual report[8] including a statement on compliance with environmental legislation and audited financial statements in line with existing regulations applying to (a) all companies with limited liability[9] (b) companies involved in public fund raising, with assets of at least Rp50 billion, or that have issued an acknowledgement of indebtedness;[10] and (c) publicly listed companies.[11]	(+): company secretaries may be expected to be cognizant/mindful of legal requirements of environmental regulations. (+): This requirement will help monitor compliance with environmental legislation.

[6] The review of the role, obligations and composition of the BOC and BOD will verify whether the BOC has guided and monitored the BOD's implementation of the SOE's long-term plan, annual business plan, and budget.

[7] In selecting the SOEs, preference will be given to those that are not to be privatized during this Program.

[8] The annual report including the audited financial statements must be in accordance with the Company Law and with the Generally Accepted Accounting Principles (GAAP) approved by the Indonesian Institute of Accountants.

[9] Consistent with Company Law, articles 56, 57, 58, and 86.

[10] Consistent with the Government Regulation No. 24/1998 dated 14 February 1998 on Corporate Annual Financial Information.

[11] In line with the Decision of the Chairman of BAPEPAM No. KEP-80/PM/1996 dated 17 January 1996 on the obligation to submit periodic financial statements.

Policy Actions	**Likely Potential Environmental Impact** **(+): Positive** **(-): Negative**
(iii) At least 80 percent of SOEs under MSOE jurisdiction will file such annual reports complying fully with legal requirements stipulated above with the Company Registrar. (iv) MSOE will publish annual reports (including audited financial statements) of SOEs with majority Government ownership on a specially designed web page accessible through the Internet. The system will also be used for SOEs to submit data to MSOE. (v) Establish audit committees in 30 SOEs annually (including one commissioner and two outside experts) that should report directly to their BOCs to evaluate the audit results of the company, review compliance of company with statutory requirements and adequacy of audit procedures, and make recommendations about the internal control systems and their implementation.	(+): Ditto **(+): Ditto** (+): Ditto
5. Capacity building for effective implementation of corporate governance mechanisms by attending corporate governance workshops covering all items in A.1. with support of Asian Development Bank (ADB), World Bank or other providers, to be attended by at least (i) 40 MSOE directors and deputy directors; (ii) all MSOE deputy ministers, directors and deputy directors; and (iii) commissioners and directors of 88 SOEs identified in A.2.	(+): Capacity building will also help strengthen environmental management
B. Public Service Obligations (PSOs)	
1. MSOE, with the support of ADB technical assistance (TA) for commercialization of PSOs, will: (i) identify PSOs in selected 15 SOEs, (ii) quantify PSO costs and environmental impact, and (iii) develop rules and regulations for tendering such services (allowing bidding by private companies) to minimize subsidies.	(+): Will help in reckoning resources for mitigating environmental impacts of PSOs.
2. MSOE will work closely with the relevant line ministries to (i) introduce the rules and regulations for tendering PSOs by private companies, to minimize subsidies; and (ii) contract[12] out the provision of selected public services in 4 SOEs to the most competitive bidder, which may or may not be the SOE previously providing the services.	(+): However, the rules for tendering PSO by private companies should require mitigation of any adverse environmental impacts of the activities.

[12] The contracting process (i.e. open tender) should give due consideration to compliance with environmental legislation in technical specifications.

Policy Actions	Likely Potential Environmental Impact **(+): Positive** (-): Negative
C. Corporate Restructuring	
1. Launch a major financial and operational review of at least 60 SOEs to (i) evaluate their commercial and financial viability and their business prospects, (ii) assess labor retrenchment requirements, and (iii) recommending assessment of compliance with environmental legislation.	(+): Will help improve compliance with environmental legislation.
2. Develop policies and procedures for the following privatization processes: employee buy-out, strategic sale, free share transfer, initial public offering (IPO), joint venture, leasing of operating assets, granting of concessions, golden share arrangement, and cash auction. This will include procedures for selecting auditors, investment bankers, and other technical advisers.	Neutral
3. Based on the review in C.1. and with assistance from ADB TA for SOE privatization and restructuring: (i) Identify 12 nonviable SOEs and SOE business lines to be discontinued, and (ii) MSOE to provide a time-bound plan and initiate liquidation of 8 SOEs.	**(+): In general, one may expect that nonviable SOEs would have been inefficiently managed, including in relation to environmental compliance.**
4. MSOE to implement corporate restructuring plans for 30 SOEs identified under C.1., with appropriate consideration for all relevant legislation and policies stipulated under this program	(+): As for C1.
5. Based on the review in C.1. and in accordance with program implementation schedule: complete an independent (non-Financial and Development Supervisory Board [BPKP]), three-year financial audit that includes remuneration and all expenses (direct as well as fringe benefits) of the members of the BOC and BOD. (i) at least 18 SOEs in 2001, (ii) at least 30 SOEs in 2002, and (iii) at least 30 SOEs in 2003.	**(+): As for C1. "Fringe benefits" may include free/subsidized transport, electricity, etc. whose rationalization will reduce environmental impacts.**
6. For SOEs identified under C.1., MSOE will determine the privatization options[13] for 30 SOEs and 12 minority shareholdings.	**Neutral: Specific privatization options adopted may not be material for environmental management.**
7. For SOEs identified under C.1. MSOE, to achieve satisfactory progress in privatizing[14]: (i) at least 7 SOEs, and (ii) at least another 8 SOEs.	(+): As for C1.
8. For minority shareholdings identified under C.1., MSOE will (i) completely sell shares in at least 5 companies in 2003 and (ii) completely sell shares in another 7 companies in 2004.	(+): As for C1.

[13] Privatization options include employee buy-out, strategic sale, free share transfer, IPO, joint venture, leasing of operating assets, granting of concessions, golden share arrangement, and cash auction

[14] For the purpose of this Program, privatization is defined as a reduction in the Government's share in the voting shares of a company (held directly or indirectly) to less than 50 percent.

Policy Actions	Likely Potential Environmental Impact **(+): Positive** (-): Negative
D. Labor Redundancies	
1. MSOE will (i) prepare a labor rationalization policy based on legal standards for severance and service payments as outlined in Presidential Decree 3/1996; (ii) facilitate establishment of a consultative working group for managing seminars and workshops on labor relation legislation, and foster dialogue between labor unions, SOE management, and MSOE; the group will expand the labor rationalization policy to include early retirement regulation and assistance for redeployment including training or retraining of workers, financing of entrepreneurial initiatives, access to pension funds, etc. Members will be selected from human resource managers in SOEs, the Federation of SOE Labor Unions, Legal Aid Society, International Labor Organization (ILO), Ministry of Manpower (MOM), MSOE, National Development Planning Agency (BAPPENAS); and (iii) approve labor rationalization policy;	Neutral
2. MSOE will implement the labor rationalization program in accordance with the policy: (i) SOEs will lodge their labor restructuring plans (including cost implications) with MSOE and MOM to provide endorsement, and (ii) MOM will record financial assistance being provided by Government to SOEs unable to meet the expenses for redundancies.	Neutral
E. Procurement	
1. MSOE will require compliance by SOEs with transparent and fair procurement practices ensuring full accountability.	(+): See E3.
2. MSOE will: (i) prepare terms of reference (TORs) for the procurement auditors; (ii) initiate random, independent or BPKP audits of the procurement by SOEs, and present audit reports to the steering committee and ADB; and (iii) publish summary findings and identify measures to recover losses and prosecute culprits for (a) 20 SOEs by 2002 and (b) another 20 SOEs by 2003	**(+): See E3**
3. Based on the results of random audits (see E. 2), MSOE will: (i) develop guidelines for the procurement of SOEs, including requirements for compliance with environmental legislation in technical specifications of tender documents, differentiated by industry groups if necessary; (ii) introduce these new guidelines for necessary action; and (iii) assure that SOEs adopt guidelines or prepare adequate procurement procedures based on the guidelines.	(+): Since procurement guidelines will require compliance with environmental legislation, adverse environmental impacts of production/extraction of inputs will be reduced.

INELIGIBLE ITEMS

1. The proceeds of the loan will be utilized to finance the foreign exchange expenditures for the reasonable cost of imported goods (excluding any duties or taxes) required during the execution of the State-Owned Enterprise Governance and Privatization Program. All imported goods financed from the proposed loan must be produced in, and procured from, member countries of the Asian Development Bank.

2. Notwithstanding the provisions of paragraph 1, no withdrawals will be made from the loan proceeds for:

(i) expenditures for goods included in the following Chapters and Codes of the Borrower's 1989 Customs Tariff:

Chapter	Code	Description of Items
22	22.03 - 22.08	alcoholic beverages and spirits
24	24.01 - 24.03	tobacco, unmanufactured; tobacco refuse; tobacco manufactured (whether or not containing tobacco substitutes); tobacco substitutes and tobacco extracts and essences
28	28.44 - 28.45.9	radioactive and associated materials
71	71.01 - 71.04	pearls; precious and semi-precious stones, unworked or worked
71	71.05 - 71.06	jewelry of gold, silver or platinum group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
71	71.08.11 - 71.08.13	gold, non-monetary (excluding gold ores and concentrates)
84	84.01	nuclear reactors, and parts thereof, fuel elements (cartridges), non-irradiated for nuclear reactors
93	93.01 - 93.07	arms and ammunitions and parts and accessories thereof;

(ii) goods intended for a military or paramilitary purpose or for luxury consumption; or

(iii) pesticides categorized as extremely hazardous or highly hazardous in Class 1a and 1b of the World Health Organization's (WHO) Classification of Pesticide by Hazard and Guidelines to Classification.