

## **PUBLIC–PRIVATE PARTNERSHIP IN INFRASTRUCTURE**

### **A. INTRODUCTION**

1. **Progress in infrastructure development.** The current administration of President Joko Widodo (Jokowi) has unveiled 11 economic packages since September 2015 in an effort to promote deregulation and support investment in key sectors. This is important to provide signal to the private sector of the government's commitment to improve investment climate and infrastructure development. The government has showed significant progress in infrastructure development. Decades of under-investment and poor asset management have left Indonesia with a major infrastructure deficit, the economic and social costs of which are substantial. There are encouraging signs coming out from the current administration. The reduction in energy subsidies has provided enough room for an increased capital spending. Investments approvals in infrastructure projects are rising fast. And, the largest construction firms have reported a large jump in the value of government-awarded contracts. On the ground, progress has also been seen. The Masassar-Parepare segment of the Trans-Sulawesi railway and the first stage of the New Priok Port at Tanjung Priok have been completed. The government has also awarded Umbulan Springs Project, which will supply water to Surabaya and surrounding area, to a preferred bidder.

2. **Infrastructure investments are insufficient.** Indonesia's annual infrastructure investment needs are estimated at 6.2% of GDP (by sector: 3.9% of GDP in transport, 1.0% of GDP in energy, 1.0% of GDP in telecommunications, and 0.4% of GDP in water and sanitation).<sup>1</sup> However, this investment is relatively low when compared with Malaysia (9.0% of GDP) and Thailand (7.0% of GDP). Improving the quality of infrastructure would require an increased public investment in infrastructure from the average of 1.5% of GDP from 2008–2012 and an increased in private participation in public infrastructure project from the average of 0.6% of GDP from 2008–2012.

3. **Poor performance in public-private partnerships.** At national level, the government has been relying on public–private partnerships (PPPs) to boost private sector participation in infrastructure from 0.6% of GDP in 2008–2012 to the average that occurred during 1995-1997, which was 2.3% of GDP. However, progress has been slow because of fragmented legal framework for PPPs, lack of solid pipeline of public infrastructure projects, lack of fiscal support for PPPs, and complex land acquisition process. As a result, Indonesia is rank low in public-private partnerships (PPPs) in global and regional comparison contrary to what one would expect given the population and economy size of the country.<sup>2</sup> Private sector participation in infrastructure outside of the energy and telecommunication sectors, as well as some limited investments in toll-roads and ports, has been minimal.

### **B. SECTOR ASSESSMENT: CONTEXT AND SELECTED STRATEGIC ISSUES**

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<sup>1</sup> ADB staff estimates with data are taken from Indonesia's National Account.

<sup>2</sup> In this note, the term public–private partnerships applies to all projects, under which private finance is used to deliver infrastructure or service, for which the government is normally responsible. In this context, PPP projects in this note refer not only to investments covered by the Presidential Regulation 67/2005 on Cooperation between Government and Business Entities in Infrastructure Provision (as amended by PR 13/2010, PR 56/2011 and PR 66/2013), but also to private investments in public infrastructure enabled through sector legal frameworks. For brevity purposes, the Presidential Regulation no 67/2005 is referred to in the next as the 2005 PPP framework.

4. **Facilitating mechanisms for public-private partnerships.** A project development facility has been piloted at Bappenas since 2006 to support development of projects arising from 2005 PPP framework. The government has also established financial mechanisms under MoF to improve creditworthiness of PPP projects: (i) Indonesia Infrastructure Guarantee Fund (IIGF) to provide government guarantees or credit enhancements only to PPP projects that are financially feasible; (ii) PT SMI to facilitate and catalyze PPP infrastructure projects through provision of debt, equity and mezzanine financing; (iii) Indonesia Infrastructure Finance, a non-bank financial institution, to provide long-term funding for infrastructure projects; and (iv) the Center for Government Investment (PIP), a public service agency at MOF, to provide advance financing for land acquisition to improve project implementation readiness. Progress has been made with improving land acquisition systems, though its full-fledge application is to start in 2015.<sup>3</sup> Overall, there seems to no constraining lack of equity or debt financing for PPPs; rather the investors and lender major concern is lack of properly prepared projects and high cost of engagement with government due to lack of effective mechanisms to timely address coordination problems among various government stakeholders.

5. **No integrated framework on private participation in infrastructure.** The country has numerous legal acts (laws, government regulations, Presidential decrees, ministerial and inter-ministerial circulars, agency level guidelines) pertaining to PPPs. Principles, procedures and requirements for government cooperation with private sector is also regulated by Government regulations on management of state/regional assets and on regional (local government) cooperation resulting an overlap and conflicting provisions. National level agencies tends to follow own legal framework for doing PPPs. Subnational governments tend to use their powers within the decentralized system and suitable sector legislation to do PPPs. Overall, the 2005 PPP framework—which is lower in legal hierarchy than PPP related sector laws and government regulations—has not been followed by government agencies, except when there was a clear need for central government guarantee or subsidy.<sup>4</sup> In order to ensure uniformity of the rules of engagement with the private sector for provision of public infrastructure and services as well as to ensure continuity of such rules among administrations as a major element for investor confidence, there is a clear case for Indonesia to have a PPP Law that would conceptualize at a cross-cutting level the state policy, principles and drivers for engagement with the private sector, introduce both concession- and availability-based PPPs,<sup>5</sup> expand coverage of PPPs to economic and social infrastructure, government's institutional set-up for PPPs, government support instruments to improve creditworthiness of projects, procedures on selection of investors, rationale for and treatment of unsolicited proposals, fiscal cost management of PPPs, dispute resolution mechanisms, investor and lender interest protection, role of SOEs as GCAs and private counterparty in PPP deals,<sup>6</sup> use of state assets in PPP projects, and other cross-

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<sup>3</sup> In 2012, the Law on Acquisition of Land for Development in the Public Interest was adopted (Law 2/2012), followed with subsequent by-laws and regulations. In 2014, a dedicated office on land acquisition in public interested was established at the National Land Agency to lead policy- and project-level work to ensure timely availability of land for public infrastructure projects.

<sup>4</sup> OECD. 2012. *Indonesia: Public-Private Partnership Governance: Policy, Process and Structure*. OECD Reviews of Regulatory Reform. September 2012.

<sup>5</sup> Current PPP framework explicitly provides only for concession-based PPPs (i.e., investment repayment is sourced from users of the facility or service). However, there seems to be no formal treatment of availability-based PPPs in the country's legal framework. This results in lack of PPPs in such sectors as education and health sectors.

<sup>6</sup> On one hand, the 2005 PPP framework does not enlist SOEs as among GCAs. Hence, SOEs cannot avail of government support mechanisms under the 2005 framework if needed for bankability of projects SOEs want to undertake with participation of the private sector. On the other hand, the 2005 framework allows SOEs—without any restriction or additional qualification requirements—to be the private counterparty in a PPP project, what conceptually undermines the PPP arrangement per se (basically, all risk remains with the public sector).

cutting elements of PPPs. Such law-anchored legitimacy of PPPs will eventually reduce the uncertainty apprehensions of the investors and lenders to ultimately result in lower bid prices and improved public interest. A PPP law would be also a logical completion of the piloting phase in mainstreaming PPPs as a regular modality to deliver public infrastructure and services, which started with adoption of the 2005 PPP framework and continued with gradual introduction of elements of PPP institutional framework and facilitating mechanisms described above.

6. **Lack of effective high-level decision-making body for PPPs.** Planning, approval and implementation of infrastructure projects has suffered from poor horizontal (among national government agencies) and vertical (between national level agencies and local governments) coordination. There is also no established government platform allowing for regular and (sub)sector or region-based interaction with domestic and international infrastructure investors and lenders to discuss and agree on solutions to address issues affecting private investment in this (sub)sector or region. The best option to ensure effective coordination is to set up an infrastructure committee (InfraCom) chaired by President or Vice-President with the heads of Bappenas, MOF, CMEA, Indonesia Investment Coordinating Board (BKPM), MOHA, and BPN as members. This committee could approve PPP projects before bidding and decide on PPP enabling environment issues. This committee would be also the only authority to approve PPP project list to be one single list to be used and adhered to by all government agencies. A technical committee (chaired by vice-minister of MOF with deputy heads of Bappenas, CMEA, BKPM, MOHA, and BPN as members) could be set up to review projects and PPP issues prior to submission to InfraCom.<sup>7</sup>

7. **Challenge of SOEs.** In Indonesia, SOEs play an important role in infrastructure asset and service delivery. However, this role is problematic for two reasons: (i) in some sectors the SOEs perform regulator and operator functions;<sup>8</sup> and (ii) SOEs may act as private counterparty in PPP bids creating a conflict of interest for government, which as the owner of the SOEs, have to decide between bids received from both the SOEs and private bidders. This situation mainly pertains to the road, ports, airports, and water sectors.

8. **Lack of an anchor PPP office.** There is currently no such unit or office in Indonesia; its functions seem to be dispersed among Bappenas (pipe-line development and preparation), MOF and SMI (preparation and structuring of projects), CMEA (infrastructure planning), and BKMP (promotion), while policy and enabling framework is covered by all of these agencies. Given this, there is a strong case for setting up a government nodal office in PPPs that would have a pool of reputable experts for PPP project preparation and transaction. Such PPP office could be located at MOF as most of PPP facilitation and enhancement mechanisms are with MOF. Such location would enhance coordination and improve timeliness of PPP office's work.

9. **Inadequate project preparation.** Proper preparation of PPP projects—technical, financial and legal dimensions to make projects attractive to investors and lenders—is the most important factor for successful roll-out of the PPP program. The pilot PDF at Bappenas provides important lessons learned to be taken into account in setting up a sustainable, reputable and quick project preparation and transaction support mechanism to be managed by the anchor PPP office. This mechanism would need to be based on a project development fund established

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<sup>7</sup> The InfraCom's technical committee could conduct regular sub-sector/region specific discussions with investors and lenders and report on these to InfraCom. To facilitate speedy delivery of the projects, the technical committee could be also given an authority for approval of projects up to a certain ceiling or other strategic criteria.

<sup>8</sup> In sectors where regulation and service provision have been separated, the regulator-operator relationship seems to be still very close.

on a revolving basis with an inter-agency committee (DG-level staff of MOF [chair], Bappenas, CMEA, and BKPM; PPP office head as secretary) to approve GCA request for funding of project preparation and transaction consultants.<sup>9</sup> Critical is to ensure that consultants—reputable and internationally selected technical, financial and legal firms—can be quickly mobilized upon approval of project preparation support.<sup>10</sup>

10. **Lack of PPP cells in GCAs.** Experience from countries with decentralized PPP framework suggests the criticality of PPP cells at GCAs. These PPP cells need to be sustainably set up, staffed and budgeted as organic structures in GCAs. Such PPP cells will be natural PPP champions in GCAs to ensure equal treatment of traditional and PPP projects in planning, programming, and processing (in other words, to ensure regularization of PPPs at GCAs). They will also ensure continuity of work from project processing to implementation monitoring and contract administration, which is important given long-term nature of PPPs. In Indonesia, institutionalization of PPP cells could start from major national-level GCAs.

### C. GOVERNMENT PPP FRAMEWORK AND RECENT DEVELOPMENTS

11. **Revision to the 2005 PPP framework.** In 2015, the government issued a new Presidential Decree on PPP, i.e. Presidential Decree No. 38. The new regulation introduced an availability payment model as a source of investment return, in addition to traditional user payments. The new regulation also provided more clarity on the treatment of unsolicited proposal. Similar to the previous regulations, unsolicited proposals can be submitted by business entities under the condition that the projects are economically and financially feasible. In this unsolicited mode, proponents are entitled to obtain one out of three possible forms of compensation: (i) additional points in the evaluation (10 percent), (ii) a right to match the offer of the first ranked bidder, and (iii) financial compensation for intellectual property rights (related to a feasibility study made by the proponent) by the government or winning bidders. The new regulation also clarifies government support and/or guarantees on PPP. MOF can approve government support by way of fiscal contributions as well as tax incentives under its criteria of risk management. Additionally, financing may be provided partially from GCAs. Notably, the selection of project companies may now be conducted through direct appointment as well as competitive bidding under specific conditions. It further clarifies that financial closure should be achieved within 12 months after PPP agreements are met, but the deadline may be extendable at most 6 months from time to time in accordance with criteria and approval by the government.

12. **Proposed mechanism for delivery of priority infrastructure projects.** The government has initiated a de-facto reorganization of the poorly performing National Committee on Acceleration of Infrastructure Development (KKPPI) set up in 2005 by (i) streamlining its structure, and (ii) assigning of clear roles and allocation of resources to CMEA (secretariat and coordination), Bappenas (preparation of pre-feasibility studies), and MOF (in case of PPPs, preparation of feasibility studies and transaction support) through a project development fund. The revived KKPPI—now called the *KPPIP*—will be accountable for delivery of priority infrastructure projects. The KPPIP will also decide—upon review of the pre-feasibility study—if the project is to be delivered using budget funds, SOE assignment, or via PPPs. Overall, the KPPIP framework seems to be a step in the right direction that could be eventually evolve in a higher-level mechanism along the lines of InfraCom described above.

<sup>9</sup> Winning bidder would pay back the incurred cost plus a defined administration fee. To mitigate moral hazard by GCAs, they would need to reimburse 100% of the PDF incurred cost if the project is cancelled mid-way, or 50% if the bidding was unsuccessful.

<sup>10</sup> One way to do this is through a panel arrangement as in the Philippines or India.

## D. ADB ASSISTANCE AND LESSONS LEARNED: HIGHLIGHTS

13. On the public sector side, ADB has supported PPPs through (i) cross-sectoral and sector-specific infrastructure and connectivity improvement policy and institutional reforms, (ii) preparation of bankable projects through PDF, and (iii) setting up long-term local currency financing mechanism through Indonesia Infrastructure Financing Facility. On the private sector side, most recent ADB debt financing involved East Jakarta water supply and Sarulla geothermal infrastructure projects based their relevant sector frameworks. In both projects, poor coordination among government agencies, fragmented legislation, challenges with setting up tariffs at cost recovery level, and exogenous economic shocks were among major issues that affected their implementation.

14. Performance of ADB-supported operations has been affected by (i) existence of parallel PPP enabling sector frameworks resulting in lack of motivation, commitment and capacity of GCAs to use PPP framework, (ii) lack of high-level government oversight and accountability mechanism for the overall PPP program, (iii) challenging design<sup>11</sup> of the project development facility (PDF) institutionally located away from the government's financing and guarantee mechanisms, and (iv) lack of adequate land acquisition framework and supporting institutions.

## E. SELECTED WAYS FORWARD

15. **Improve the 2005 PPP framework.** Among areas that need proper mainstreaming in the 2005 PPP framework are (i) explicit introduction of availability-based type of PPPs, (ii) expansion of scope to also cover social infrastructure, (iii) recognition of state-owned enterprises (SOE) as government contracting authorities to improve transparency and enable improve bankability of SOE PPPs through government support schemes, (iv) qualifying SOE participation in PPPs as business entity to mitigate distortion of competition and adverse fiscal impact, (v) enabling PPP projects with existing state assets to avail of government support schemes, (vi) laying out the key features and governance arrangements of an anchor PPP office and PDF, (vii) setting up a governmental committee on PPPs to appraise and approve projects prior to bidding or market contest, and improve PPP enabling environment to address emerging legal and agency coordination problems, and (viii) encouragement to setting up of PPP cells at GCAs.<sup>12</sup> As input to the improvement of the 2005 PPP framework and in order to ensure that this framework is in-sync with the existing PPP facilities, there should be assessments conducted on the effectiveness of existing guarantee mechanisms (e.g., business viability guarantees, guarantees via IIGF), various land funds, geothermal facility, and the VGF mechanism. Additionally, the PPP framework and Government regulations on state/regional assets management and on local government cooperation need to be harmonized as well.

16. **Operationalize KPIP mechanism** that would (i) set up an inter-agency committee with clear decision-making authority over preparation and implementation of priority infrastructure projects; (ii) assign clear responsibilities to Bappenas (prioritization of projects and development

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<sup>11</sup> Lack of strategic selectivity, long consultant selection process, inadequate focus on financial and legal dimensions during project preparation, discretionary decisions on allocation of PDF support, and ineffective countering of moral hazard by GCAs in the use of PDF.

<sup>12</sup> This would entail (i) development of methodology to assess PPP readiness of GCAs, (ii) conduct pilot assessment of selected GCA PPP readiness, and (iii) develop institutional and staff capacity building plans for selected GCAs, including design of GCA PPP units and legal framework, standard operating procedures, structured project finance trainings reflecting Indonesia's PPP framework elements.

of pre-feasibility studies for all priority infrastructure projects), CMEA (coordination, quality enhancement, and validation of studies), MOF (development of feasibility studies and transaction of PPP projects) to support GCAs in expedited project delivery; and (iii) give MOF the mandate to set up a project development fund to cover cost of preparation of feasibility studies and transaction support to PPP projects.

17. **Increasing the capacity of PPP office at MOF.** Such office will need to be properly equipped with thoroughly designed standard operating procedures, be properly integrated in all MOF-housed PPP mechanisms, and adequately staffed to facilitate preparation of bankable PPP infrastructure projects by (i) managing a project development fund to cover the cost of internationally recruited transaction advisors, (ii) ensuring optimal allocation of risks between government and investors in the proposed PPP contracts, (iii) evaluating project documents for approving government support to enhance credit worthiness of projects, (iv) monitoring implementation of PPP projects after award to ensure timely financial close and start of implementation, (v) developing and updating standard documents for PPP projects (outline and full business case templates adjusted to reflect country context and requirements of PPP facilitation mechanisms, sub-sector specific standard bidding documents, risk allocation matrices, draft contracts, contract management plans), and (vi) maintaining a PPP knowledge management portal to ensure proper information management for better decision making.

18. **Improve project preparation mechanism** based on lessons learned from PDF at Bappenas. Funding for project preparation and transaction would come from the project development fund envisaged to be set up under KPPIP. For the mechanism to be successful, it has to ensure that (i) internationally reputable financial, legal, and technical firms are engaged for project preparation and transaction, and (ii) that such consultant firms are mobilized quickly upon approval of support from the project development fund.

19. **Strengthen land acquisition office at NLA.** Effectiveness of the newly set-up land acquisition office will be very important in ensuring speedy financial close and start of implementation of PPP projects. In this respect, among issues this office would need to focus on would be (i) development of manual/guidelines for government agencies on land acquisition process and requirements throughout the PPP project cycle, and (ii) conduct a public awareness campaign on the new office and its processes among GCAs. At the initial stage, the office may also benefit from on-call advisors with expertise in land acquisition and resettlement in PPP projects to help with issues upon their emergence in the real life PPP projects.

20. **Conceptualize a PPP law with an effective high-level decision making mechanism.** As the first step in preparing a PPP law, it will be important to develop—with comprehensive consultations with all stake-holders—academic papers on a (i) PPP law as an integrated cross-sectoral policy, legal, institutional, and procedural framework for private investment in provision of public infrastructure and services, and (ii) government institutional mechanism to decide on integrated infrastructure planning and implementation to ensure cooperation and accountability among national government agencies and sub-national governments.