ADB

Report and Recommendation of the President to the Board of Directors

Project Number: INO 40009
October 2006

Proposed Program Cluster, Loans, Technical Assistance Grant, and Administration of Grant from the Government of the Netherlands

Republic of Indonesia: Infrastructure Reform Sector Development Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 15 September 2006)

Currency Unit	–	rupiah (Rp)
Rp1.00	=	$0.000109
$1.00	=	Rp9,130

ABBREVIATIONS

ADB	–	Asian Development Bank
BAPPENAS	–	Badan Perancanaan Pembangunan Nasional (National Development Planning Agency)
BPJT	–	Badan Pengatur Jalan Toll (Indonesian Toll Road Authority)
BPP SPAM	–	Badan Pendukung Pengembangan Sistem Penyediaan Air Minimum (National Water Regulatory Agency)
BRTI	–	Badan Regulasi Telekomunikasi Indonesia (Indonesian Telecommunications Regulatory Body)
BUMD	–	Badan Usaha Milik Daerah (local government owned enterprise)
CBM	–	coal bed methane
CIIF	–	Consolidated Indonesia Infrastructure Forum
CMEA	–	Coordinating Ministry of Economic Affairs
GDP	–	Gross domestic product
IIS	–	Indonesia Infrastructure Summit
IPP	–	independent power producer
IRSDP	–	Infrastructure Reform Sector Development Program
JBIC	–	Japan Bank for International Cooperation
KAI	–	PT Kereta Api Indonesia (Indonesian Railway Corporation)
KKPPI	–	National Committee on the Acceleration of Infrastructure Development
km	–	Kilometer
MEMR	–	Ministry of Energy and Mineral Resources
MOF	–	Ministry of Finance
MOT	–	Ministry of Transportation
MPW	–	Ministry of Public Works
NPDF	–	national component of the project development facility
NPRS		National Poverty Reduction Strategy
PDAM	–	Perusahaan Daerah Air Minum (regional water supply company)
PDF	–	project development facility
PELINDO	–	PT Pelabuhan Indonesia (Indonesian Port Corporation)
Perpres	–	presidential regulation
PLN	–	PT Perusahaan Listrik Negara (State Electricity Corporation)
PMU	–	project management unit
PPP	–	Public-private partnership
PSO	–	Public service obligation
PSP	–	private sector participation
RMU	–	Risk Management Unit
RPDF	–	regional component of the project development facility
RPJM	–	Rencana Pembangunan Jangka Menengah (Medium-Term Development Plan)
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTES

(i) The fiscal year of the Government and its agencies ends on 31 December.
(ii) In this report, "$" refers to US dollars.

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CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower	Republic of Indonesia (Indonesia)
The Proposal	The proposal comprises (i) use of the program cluster concept for the Infrastructure Reform Sector Development Program (IRSDP), which comprises three subprograms; (ii) a loan of $400 million for subprogram 1 of the IRSDP; (iii) a loan of $26.5 million equivalent to establish an infrastructure project development facility (PDF) to support the preparation, bidding and transaction execution of national and decentralized infrastructure projects; (iv) a technical assistance (TA) grant of $2.0 million for Enhancing Private Sector Participation (PSP) in Infrastructure Provision; and (v) Asian Development Bank (ADB) administration of a $7.6 million grant provided by the Government of the Netherlands to support the establishment and operation of the PDF.
Classification	Targeting classification: General intervention Sector: Multisector Themes: Sustainable economic growth, Private sector development, Governance Subthemes: Physical infrastructure development; public-private partnerships; economic efficiency and markets; capacity development
Environment Assessment	Category C
The Program Rationale	Combined public and private sector investments in the infrastructure sectors in Indonesia exceeded 5% of gross domestic product (GDP) in the mid-1990s. The Asian financial crisis of 1997 led to a steep decline in overall development spending, and particularly infrastructure investments. Since 1998, private sector investment has almost disappeared. At the same time, the Government realized that the public sector had borne a disproportionate share of the risks in the infrastructure sectors, and stopped providing any risk-sharing support. As a result, Indonesia has lost its place as one of the top performers in terms of infrastructure provision in the Southeast Asian region. With infrastructure investments currently at around 2% of GDP, about 50 million people (or more than 20% of the population) do not have access to treated water, 90 million are without electricity, and about 200 million without fixed telephone lines or connections to a sewerage network. The poor suffer disproportionately from lack of access to basic infrastructure services. Availability of services is generally lower in rural areas, particularly outside Java and Bali, contributing to significant regional disparities in development. The Government estimates that about $65 billion will be needed in new infrastructure investments over the next 5 years, with $25 billion (38%) to be met from the government budget; $14 billion (22%) by domestic banks, and insurance and pension funds; $10 billion (15%) by multilateral and bilateral development partners; and $16 billion (25%) by domestic and foreign private sector investors.

Given the weak investment climate, the Government recognizes that PSP cannot be taken for granted, and serious structural and institutional reforms are needed. At the January 2005 Indonesia Infrastructure Summit, the Government announced its commitment to promote PSP and identified 91 potential infrastructure projects. It has since introduced several critical measures to strengthen the regulatory and institutional framework for PSP. The February 2006 comprehensive Infrastructure Policy Package outlines the short-term reform agenda in various infrastructure sectors. The IRSDP, formulated at the Government's request in consultation with all stakeholders and development partners, is based on this agenda and extends it over the medium term.

Impact and Outcome

The IRSDP will improve the investment climate and support timely realization of the Government's medium-term macroeconomic goals, in particular achieving average annual GDP growth of 6%–7% during 2005–2009, through enhanced provision of, and access to, infrastructure. The expected outcome of the IRSDP is accelerated infrastructure development through large-scale PSP and mobilization of additional public sector resources.

The Program Loan

Impact and Outcome

The program loans for the IRSDP support three key reform pillars:

(i) Strategic cross-sectoral reforms resulting in
- (a) improved policy, legal, and institutional frameworks for greater PSP anchored on good governance principles;
- (b) a well-structured risk management framework to promote PSP;
- (c) accelerated mobilization of domestic long-term financial resources for infrastructure development through public-private partnership (PPP) projects; and
- (d) a streamlined regional autonomy framework delineating functional responsibilities for infrastructure provision by national and local governments.

(ii) Sector-specific reforms for transportation, power, oil and gas, water supply and sanitation, and telecommunications leading to
- (a) improved financial soundness and sustainability of infrastructure services through full cost recovery;
- (b) greater competition that benefits consumers by improving services and lowering tariffs;
- (c) independent regulatory structures that are distinct from contracting and operating functions;
- (d) equal access for all participants/investors, and the prevention of abuse of natural monopoly rights; and
- (e) fulfillment of public service obligations of infrastructure service providers, in line with the Government's poverty reduction objective.

(iii) Facilitation of the preparation and execution of well-structured model PPP projects that can be replicated.

Program Investment Plan	For subprogram 1, the Government has requested ADB to provide a loan of $400 million. The Government envisages support from ADB of around $300 million–$400 million for each of subprograms 2 and 3, which will be reconfirmed during IRSDP review and processing. The Government has requested the Government of Japan and the World Bank to cofinance the IRSDP; this is being considered by the development partners.
Financing Plan	A loan of $400 million from ADB's ordinary capital resources for subprogram 1 will be provided under ADB's London interbank offered rate (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% per annum; and such other terms and conditions set forth in the draft program loan agreement.
Program Period and Tranching	Subprogram 1 was implemented from January 2005 to September 2006, and all actions included in the policy matrix under subprogram 1 are complete. Subprogram 2 will be implemented from October 2006 to June 2008, and subprogram 3 from July 2008 to March 2010. All three program loans will be disbursed in single tranches upon declaration of their effectiveness.
Executing Agency	The National Development Planning Agency (BAPPENAS), under the overall coordination of the National Committee on the Acceleration of Infrastructure Development (KKPPI) will be the Executing Agency. BAPPENAS will closely collaborate with the Coordinating Ministry of Economic Affairs, Ministry of Finance, and the concerned line ministries in executing the IRSDP. The line ministries and agencies will implement the reform actions.
Procurement	The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. The loan proceeds will be disbursed to the Borrower in accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*.

The Project Loan

Impact and Outcome	The project loan is to help accelerate PSP in Indonesia's infrastructure sectors. Establishment of the PDF will alleviate one of the most critical constraints impeding infrastructure development, namely, the lack of adequate project preparation. The PDF will help the Government (i) prepare feasibility studies for national and decentralized PPP projects; (ii) adopt open and transparent bidding processes; and (iii) execute project transactions. Resources will be allocated through a national component of the PDF focusing on large national projects, and a regional component of the PDF supporting smaller decentralized projects of local governments.

Financing Plan

A loan of $26.5 million equivalent from ADB's Special Funds resources will be provided. The loan will have a 32-year fixed term including a grace period of 8 years, a 1% interest charge during the grace period, and 1.5% thereafter, and such other terms and conditions as are set forth in the draft Project Loan Agreement. The loan will be supplemented by a $7.6 million grant from the Government of the Netherlands to be administered by ADB. Disbursement procedures will be in accordance with ADB's *Loan Disbursement Handbook*.

Executing Agency and Implementation Arrangements

BAPPENAS will be Executing Agency for the Project. The head of the Directorate for PPPs in BAPPENAS will be the overall project director for the PDF on behalf of the Government. A project management unit will be established to administer the PDF. For the local government projects, a steering committee chaired by the BAPPENAS deputy for infrastructure affairs and including senior representatives of the Coordinating Ministry for Economic Affairs, Ministry of Finance, Ministry of Home Affairs, and the concerned line ministries, plus a representative of the associations of regional governments (on a rotational basis), will be created. The Project will be implemented over 5 years.

Consulting Services and Procurement

About 552 person-months of international consulting inputs and 3,401 person-months of national consulting services will be required. The consultants will be recruited in line with ADB's *Guidelines on the Use of Consultants*. Procurement of goods and services will follow ADB's *Procurements Guidelines*.

Technical Assistance

The Government has asked ADB for TA support for (i) effectively implementing the risk management framework adopted under the IRSDP; (ii) establishing various infrastructure funds, with focus on ensuring their fiduciary governance; (iii) developing an effective communication strategy and social marketing to disseminate information and build support for reforms; and (iv) ensuring the quality of projects at entry to the PDF. The total cost of the TA is estimated at $2,500,000, of which $2,000,000 will be provided as a grant from the ADB-funded TA funding program.

Program Benefits and Beneficiaries

The IRSDP's expected benefits include

(i) sustained progress in meeting the Government's macroeconomic objectives articulated in its Medium-Term Development Plan for 2006–2009;
(ii) improved investment climate resulting from sound policy, legal, and institutional frameworks in the infrastructure sectors;
(iii) greater PSP and a more systematic approach for implementing PPP transactions focusing on good governance;
(iv) a transparent and prudent risk-sharing system;
(v) quality infrastructure projects prepared and executed transparently and expeditiously, resulting in (a) improved availability and quality of infrastructure services, (b) a boost to Indonesia's competitiveness versus its regional

neighbors, and (c) lower poverty incidence;

(vi) sustained engagement by ADB in policy reforms over the medium term to strengthen the investment climate; and

(vii) aid harmonization by the primary development partners (ADB, World Bank, and Government of Japan) around a common policy framework, and the positive externalities resulting from joint endorsement of the Government's reform agenda.

Risks and Assumptions

Lack of Coordination and Conflict of Interest. Progress in infrastructure reforms in the past was impeded by the lack of coordination among line ministries and competing and conflicting interests of various stakeholders. In particular, bureaucratic as well as political economy factors prevented restructuring of key infrastructure institutions and sector liberalization. Vested interests may still continue to oppose transparent bidding processes and favor politically connected entities. Such interests may exert pressure on the Government to share risks in an imprudent manner, or circumvent the legal and regulatory framework to prevent large-scale PSP. Recognizing past deficiencies, the Government has adopted a sound legal, regulatory, and risk management framework and coordination mechanism to promote PSP, and is committed to introducing competition and reducing the costs of infrastructure provision. The IRSDP will help reduce the risks and promote PPPs by (i) leveraging reforms that improve the investment climate to meet the medium-term growth objectives, including the adoption of institutional mechanisms to coordinate PPP projects at the oversight and line ministry levels; (ii) supporting the determination of risk sharing in a prudent and transparent manner; and (iii) bringing as many high-value projects as possible for open and transparent bidding and execution.

Poor Governance and Corruption. With the high stakes involved in large infrastructure projects, the IRSDP faces significant risks in the form of weak governance, collusion, and corruption. Such problems have been common in the past in Indonesia. However, during the last year the Government has considerably strengthened its anticorruption efforts. Procurement reforms have been under way for some time, resulting in competitive and relatively transparent selection of bidders by the public sector. The PSP regulatory framework, adopted as part of the IRSDP, sets out clear guidelines for the selection of private sector sponsors. The National Committee on the Acceleration of Infrastructure Development is tasked with ensuring that bidding processes are fair and transparent. The President has enhanced the profile and activities of the Anti-Corruption Commission and other law enforcement agencies considerably. These steps are already having an impact.

Social Tensions. Tariff reforms are sensitive in any environment, and Indonesia is no exception. As the country gradually moves away from the current system of administered tariffs for infrastructure services, social tensions will be inevitable. However, the savings from the reduction in inefficient subsidies will enable the Government to reorient its public expenditures to poverty reduction, employment generation,

and rural infrastructure development.

Adverse Domestic and Regional Economic Developments. PSP could be impeded by domestic macroeconomic volatility, lack of sustained momentum on policy reforms, or adverse regional events that have a contagion effect on the Indonesian economy. Over the last few years, the Indonesian economy has been quite resilient to domestic and external shocks. The Government has begun adopting wide-ranging reforms to address investors' concerns.

Heightened Security Alerts Stemming from Sectarian and Regional Conflicts, and Security Concerns. The Government and its law enforcement authorities have taken a range of effective measures against such conflicts that could slow private investment, and to rebuild public and investor confidence.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed program cluster for the Infrastructure Reform Sector Development Program (IRSDP) in the Republic of Indonesia comprising three subprograms; (ii) a proposed loan to the Republic of Indonesia for subprogram 1 of the IRSDP; (iii) a proposed loan to the Republic of Indonesia for the establishment and operation of an Infrastructure Project Development Facility (PDF); (iv) proposed technical assistance (TA) for Enhancing Private Sector Participation (PSP) in Infrastructure Provision; and (v) proposed administration of a grant to be provided by the Government of Netherlands for the PDF. The design and monitoring framework is in Appendix 1.

II. THE SECTOR: PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

A. Sector Description and Performance

2. Until the 1997 financial crisis, Indonesia successfully used infrastructure development to address poverty reduction and economic development. However, infrastructure investments, which accounted for more than 6% of annual gross domestic product (GDP) before 1997, have fallen to 2% in recent years, reflecting a sharp decline in public and private spending. The financial crisis greatly aggravated the situation; many planned public and private infrastructure projects were canceled or suspended. Since 1997, only some basic preservation and maintenance of infrastructure, with very little expansion, have taken place.

3. Current infrastructure service coverage in Indonesia is low by regional standards. In 1996, Indonesia outperformed the People's Republic of China, Sri Lanka, and Thailand in terms of overall infrastructure quality. However, by 2004 these countries had overtaken Indonesia, which ranked 64th of the 80 countries surveyed.[1] About 50 million people lack access to treated water, 90 million to electricity, and close to 200 million do not have direct access to telecommunications or connections to a sewerage network (Box 1). The poor suffer disproportionately from lack of access. Moreover, the generally lower availability in rural areas, particularly outside Java and Bali, contributes to significant regional disparities in development.

4. While the financial crisis impeded development and growth in all of Southeast Asia, it is not the sole reason for the poor state of infrastructure sectors in Indonesia. Supported by the economic boom prior to the crisis, investment decisions under the New Order regime were made on the basis of political connections, rather than a clear and impartial judgment of the associated risks, benefits, and costs. As a result, the public sector absorbed a disproportionate share of the risks. In addition, no concerted effort was made to address the various policy, legal, and institutional impediments facing the infrastructure sectors. Subsequent governments during 1998–2004 were burdened with the more urgent tasks of financial sector restructuring and fiscal consolidation. Efforts were directed to mitigate risks by renegotiating major infrastructure contracts signed before the crisis. Initial steps were also taken to put in place an interministerial mechanism to coordinate infrastructure development.

5. Following Indonesia's first direct presidential elections in October 2004, the current Government set ambitious macroeconomic targets for the Medium-Term Development Plan (RPJM: 2005–2009) to be achieved by 2009: (i) accelerate GDP growth from 4.5% in 2004 to 7.6% (with an annual average of 6.6%), (ii) increase the investment/GDP ratio from 20.5% in

[1] World Economic Forum. 2004. *Global Competitiveness Report 2004–2005.* Geneva. In 2006, this ranking changed to 89th out of the 125 countries surveyed in terms of basic infrastructure provision, in relation to Thailand (38), People's Republic of China (60) and Sri Lanka (76). World Economic Forum. 2006. *Global Competitiveness Report 2006–2007*. Geneva.

2003 to 28.4%, (iii) reduce the unemployment rate from 9.7% in 2004 to 5.1%, and (iv) halve the poverty rate from 16.6% in 2004 to 8.2%. The Government recognizes that major infrastructure expansion is required to remove existing bottlenecks, increase service coverage, and attract private sector investment to help achieve and sustain the projected economic growth.

Box 1: Provision of Infrastructure in Indonesia

Indonesia, which outperformed its regional neighbors in infrastructure provision until the Asian financial crisis, now lags far behind. Annual public and private infrastructure investments as a share of the gross domestic product declined to 1% in 2000 from more than 6% in the early 1990s, before recovering to around 2% in 2005. Foreign investments in productive sectors also declined. The gaps in infrastructure provision and access are significant:

- **Roads.** Indonesia has the lowest road density in the region of 0.19 kilometer (km) per square km or 1.7 km per 1,000 people.
- **Power.** The State Electricity Corporation connected on average about 1 million new customers per annum during 1974–2004. With more than 90 million people still lacking access to electricity, Indonesia will be unable to meet its 90% electrification target for 2020 unless investments are restored and the connection program is accelerated.
- **Water supply and sanitation.** Only about 40 million people or 18% of the population are connected to a piped water supply; even in urban areas only 33% have access to piped water. Indonesia has one of the lowest rates of urban sewerage coverage in Asia. As a result, the incidence of waterborne diseases is high, and diarrhea is the second largest cause of death among young children. Indonesia is unlikely to meet the Millennium Development Goal target number 10.
- **Telecommunications.** Access is among the lowest in the region, with only about 4 fixed lines per 100 people, compared to 18–20 fixed lines elsewhere.

Source: ADB staff

6. In early 2005, the Government estimated that about $145 billion would be needed for infrastructure expansion during 2005–2009. Since then, based on updated assessments and more realistic forecasts of potential investment flows, it has revised the estimate down to about $65 billion, with $25 billion (38%) to be met from the Government budget, $14 billion (22%) by domestic banks and insurance and pension funds, $10 billion (15%) by multilateral and bilateral development partners, and $16 billion (25%) by domestic and foreign private sector investors. With investments at this level, infrastructure investments would again reach about 5-6% of GDP, considered to be the minimum required to restore precrisis levels of infrastructure provision and support RPJM targets.

7. The Government recognizes that PSP cannot be taken for granted, unless serious structural and institutional reforms are implemented. Broad-ranging policy reforms are critical to improve the investment climate, including (i) liberalizing markets to allow competition and entry by new service providers, (ii) improving legal and regulatory certainty and strengthening regulatory arrangements, (iii) introducing tariff regimes based on full cost recovery or providing compensation to meet public service obligations (PSOs), and (iv) establishing effective mechanisms for dispute resolution. In January 2005, the Indonesia Infrastructure Summit (IIS) provided a platform for the Government to articulate its commitment to reform.[2] This commitment, together with a list of short-term actions, is recorded in the *Declaration of Action on Developing Infrastructure and Public Private Partnerships* approved at the IIS.

[2] More than 700 delegates attended the IIS representing the public and private sector, development partners, civil society, and media. The Government was represented by the President, vice president, and all ministers concerned with infrastructure.

8. In January 2005, at the Consultative Group on Indonesia meeting, following the IIS, the Government asked the Asian Development Bank (ADB) to support infrastructure reforms over the medium term, and thereby help implement the RPJM. ADB has been engaged in policy dialogue with the Government and other principal development partners since early 2005. For the IIS, ADB, the Japan Bank for International Cooperation (JBIC), and the World Bank jointly prepared six policy briefs on issues and constraints facing the main infrastructure sectors, and on recommendations for reform. Subsequently, in May 2005 the Government of Indonesia and the Government of Japan jointly adopted the Strategic Investment Action Plan to improve the investment climate. The plan includes many infrastructure-related actions. Building on these, the Government has taken a range of initial critical steps to set the pace for reform. In February 2006, the Government released the Infrastructure Policy Package, based on work by the line ministries, oversight agencies, ADB, Government of Japan, and World Bank. The package describes 50 actions completed in 2005, and 153 actions to be implemented during 2006.

9. The IRSDP, using the Infrastructure Policy Package as its anchor, extends the 2005–2006 actions until 2009. The Government will announce this medium-term reform agenda to investors at the second IIS, scheduled for November 2006. Given the centrality of infrastructure reforms for the RPJM, the Indonesia Government has asked the Government of Japan and the World Bank to cofinance the IRSDP, which they are currently considering.

10. As part of the discussions on ADB's new country strategy and program for Indonesia for 2006–2009, the Government asked ADB to work toward a credible medium-term commitment of resources to support one of the proposed main areas of engagement, namely, infrastructure and infrastructure services. The IRSDP structure as a program cluster is intended to provide an overall umbrella for that kind of commitment. Subject to satisfactory progress, the three subprograms will be phased at intervals of about 21 months.

B. Issues and Opportunities

1. Issues

11. Broad-based economic liberalization and restructuring, followed by fiscal consolidation, have enabled Indonesia to resume steady economic growth. After the post-crisis contraction of negative 13.1% in 1998 and 0.8% in 1999, real GDP growth rose to 5.6% in 2005. During the same period, the overall budget deficit declined from around 4% of GDP to 0.5%, and the outstanding debt stock fell from around 100% of GDP to 45%. In March and October 2005, the Government increased domestic oil prices by 49% and 126%. In previous years, Indonesia's national budgets allocated $4 billion–$7 billion per annum for inefficient, untargeted fuel subsidies to cushion domestic consumers from the higher global oil prices. The sharp reduction of the fuel subsidies, which became unsustainable at the $60–$70 per barrel world market prices, created additional fiscal space, facilitating a reorientation of public spending to meet essential education, health, and infrastructure needs.

12. The primary infrastructure issues and constraints are discussed in Appendix 2. All sectors lag Indonesia's neighbors in terms of service coverage and their investment needs are much higher than the public sector can mobilize on its own (Appendix 2, Figure A2). This underlines the need for prioritization, with public sector resources used for basic infrastructure such as rural roads, rural electrification, and water supply and sanitation in rural and low-income urban areas, i.e., interventions of a noncommercial nature that have a strong impact on poverty reduction. Financing from multilateral and bilateral development partners should be used for this purpose as well. The development partners will also play an important role in helping the Government create a conducive environment for large-scale PSP that is crucial for meeting the massive investment requirements, and attract private sector investment to public-private

partnerships (PPPs)[3] for commercially viable infrastructure projects. The IRSDP will help Indonesia realize the potential for PSP and leverage public sector resources to reduce service coverage gaps.

a. Legal and Regulatory Impediments

13. **Cross-Sectoral Framework for PSP**. PSP in infrastructure sectors reached about $1.5 billion in 1994, well below the public sector investment in infrastructure of about $8.0 billion. Both peaked in 1996, with PSP accounting for $6.5 billion of the total investment of $16.0 billion. This was followed by a sharp downturn after 1997. To revive private investments in infrastructure, an effective legal framework is critical. The presidential decree, issued after the onset of the Asian financial crisis, did not meet this purpose.[4] Although it defined PSP and called for the selection of private sector sponsors through open and transparent bidding, the decree adopted a simplistic approach and left many critical questions on the PPP scope, implementation, performance norms, tariffs, and dispute resolution unanswered. In the absence of an overall infrastructure law, a revision of this decree is considered to be the best way to provide an adequate legal framework.

14. **Sector-Specific Legal and Regulatory Framework.** The legal and regulatory framework is complex in Indonesia's infrastructure sectors. The division of responsibilities for the five principal functions—policy making, sector planning, regulation, contracting, and operation—currently differs from sector to sector (Table 1). While the line ministries in charge of infrastructure[5] are uniformly responsible for policy making and sector planning, they sometimes also have regulatory responsibilities. In other cases, they have partly or fully delegated this responsibility to recently established regulatory bodies that still report to the minister and are funded from the line ministry budget. In some cases, the regulatory bodies also have contracting functions. In other cases, the contracting function is undertaken by state-owned enterprises (SOEs) that are the main operators in the sector. Two issues need to be addressed: (i) the appropriate role of the state and SOEs in the policy making, planning, regulatory, contracting, and operator functions; and (ii) the need for equal opportunities for private sector operations.

15. SOEs have a pervasive role across all the sectors and dominate sea and air transportation, railways, and electricity. Private enterprises have to compete with these SOEs, which tend to be better established. Telecommunications is an exception, and the Government is committed to enhancing competition by moving away from the current duopoly in the market. Four of the nine sectors have established nominally independent regulatory authorities, though they report to the concerned line ministries and some perform contracting functions. In essence, the plethora of agencies involved and their complex interrelationships in sector functions have

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[3] PPPs are contractual arrangements between the public sector and a private sector party for the private delivery of public infrastructure services. They range from service contracts to management contracts to leases to concessions, such as build-own-operate-transfer contracts, to divestiture and build-own-operate contracts, and frequently involve complementary investments and/or services. Examples include private investments in power generation that are complemented by public investments in power transmission and distribution; involvement of a strategic private investor in the implementation and operation of a gas transmission project undertaken by the state gas corporation; implementation of a network of feeder roads or provision of land by the public sector to supplement a privately financed and operated toll road; provision of airside facilities (such as runways and aprons) by the public sector with private investors providing landside facilities (such as terminals and their operation); and provision of port infrastructure by the public sector with a private investor being awarded a concession for port operation.

[4] Presidential Decree 7/1998 on *Cooperation between the Government and Private Companies in the Development and/or Management of Infrastructure*.

[5] The Ministry of Energy and Mineral Resources for oil, gas, and power; Ministry of Public Works for roads, water supply, and sanitation; Ministry of Transportation for ports, airports, and railways; and Ministry of Communications and Informatics for telecommunications.

stymied reforms and made coordination difficult. A thorough review of the regulatory framework is essential, followed by changes over the medium term to enhance efficiency.

Table 1: Summary of Sector Regulatory Frameworks

Sector	Policy Making and Planning	Regulator	Contracting	Operator
Land Transport	MOT	MOT	MOT and local governments	Local governments, SOE, and the private sector
Toll Roads	MPW	BPJT (not fully independent)	BPJT	Government, SOE, and the private sector
Railways	MOT	MOT	PT KAI	SOE monopoly (contracting only through the SOE)
Ports and Airports	MOT	MOT	MOT, local governments, and SOE	MOT, local governments, and SOE monopoly (contracting only through the SOE)
Power	MEMR	MEMR	PT PLN	SOE monopoly, but with IPPs
Oil and Gas (upstream)	MEMR	MEMR	BP Migas	SOE and the private sector (open competition)
Oil and Gas (downstream)	MEMR	MEMR and BPH Migas	BPH Migas	SOE and the private sector (open competition)
Telecommunications	MOC	BRTI (not fully independent)		SOE and the private sector (open competition)
Water Supply and Sanitation	MPW	BPP-SPAM (not fully independent)	Local Governments	SOE and the private sector (open competition)

BPJT = Indonesian Toll Road Authority; BP Migas and BPH Migas = gas contracting and regulatory bodies; BPP-SPAM = National Water Regulatory Agency; BRTI = Indonesian Telecommunications Regulatory Body; IPP = independent power producer; MCI = Ministry of Communications and Informatics; MEMR = Ministry of Energy and Mineral Resources; MOT = Ministry of Transport; MPW = Ministry of Public Works; PT KAI = Indonesian Railway Corporation; and PT PLN = State Electricity Corporation.
Note**:** Ports do not include shipping, and airports do not include civil aviation. In both cases, the private sector can participate, e.g., in operating shipping lines and airlines.
Source: Asian Development Bank staff.

b. Resource Constraints Impeding Public and Private Investments

16. **Lack of Focus on and Resources for Project Preparation.** An important prerequisite for PSP is adequacy and consistency of information needed for investment decisions. This has been constrained by (i) lack of resources for sector planning; and (ii) line ministries and contracting agencies not focusing on, or providing adequate resources for, project preparation because of fiscal constraints. Prior to the crisis, Indonesia had a well-established system for preparing annual and medium-term sector plans that identified targets for infrastructure provision and developed investment plans for achieving the targets. However, due to lack of resources for plan preparation—and, more importantly, for actual public investment in infrastructure—planning capacity in some sectors was eroded. Sector development plans describing long-term physical expansion and sector blueprints outlining long-term vision in terms of restructuring and competition should be prepared or, if already available, updated. To accomplish this, the planning functions and capacity of line ministries need to be strengthened, in accordance with the gradual shift in the role of the Government from service provider to policy maker, planner, coordinator, and facilitator. Strong central coordination is essential to ensure a consistent approach to PSP across infrastructure sectors and efficient use of available funds by the line ministries.

17. Lack of capacity and resources and the absence of a systematic process have also led to lack of attention to project preparation. While the budget system does allow line ministries and agencies to obtain some resources for preparing feasibility studies, the widespread view is

that for PPP projects, this work should be done by the private sector sponsors. Once projects are identified and some preparation done, the critical steps of procurement and transaction execution also generally suffer from resource constraints.

18. **Lack of a Sound Risk Management Framework.** In the first half of the 1990s, unsolicited project proposals from politically connected private sector parties created large public sector liabilities that were highlighted by the Asian financial crisis, particularly in the power sector. Now the Government is very cautious in offering support to private sector investors.[6] At the same time, the Government is aware of the importance of adequate risk mitigation and sharing to attract large-scale PSP. A sound investment climate, supported by reduced investor perception of corruption, would be the best risk mitigation mechanism. This would entail continuous and sustained policy reforms that lead to a stable macroeconomic environment, well-functioning judicial system, independent and technically sound regulation, full cost recovery in infrastructure services (or a well-targeted output-based subsidy where the full cost recovery would make such services unaffordable), and open access in the infrastructure sectors. During the transition before these ideal conditions are achieved and confidence fully restored, private investors will ask for government support to help mitigate risks that are not under their control. The principal lesson is that the previous practice of blanket guarantees should not be repeated. The various risks in each sector and for each project type need to be identified, and then allocated to the party that can best control them. No universal solution is applicable to all situations, and the range of possible solutions is wide, depending on the specific circumstances of each case. The provision of adequate resources to SOEs to fulfill their PSOs may be one natural way of mitigating the potential default risk of those entities. The other important lesson is that risk allocation should not be rigid. Risks should gradually be transferred from the public sector to private investors as conditions improve, until market instruments rather than government guarantees can be used for risk hedging.

19. **Lack of Adequate Cost Recovery.** Given the multiplicity of agencies involved and with SOEs playing a key role in many sectors, tariffs are usually administered for infrastructure services. Most notably for power, oil and gas, air transport, and water supply, national or local parliamentary approval or presidential regulations with parliamentary consensus are needed for tariff increases. Indonesia has done quite well in the power, and oil and gas sectors. However prices are still not on par with international prices for oil and gas and do not reflect actual costs for electricity as they are not subject to automatic adjustments. The average electricity tariff was increased by 29% in 2000, 17% during July-October 2001, and through quarterly adjustments of 6% each during 2002–2003. These increases brought the average tariff from about $0.025/kilowatt-hour (kWh) after the Asian financial crisis to $0.068/kWh in late 2003, a major accomplishment and proof of the successful socialization by the Government in this highly sensitive area. Since then, the average tariff has decreased to $0.062/kWh due to rupiah depreciation and changes in the consumption structure. The Government increased fuel oil prices by 29% and 126% in March and October 2005, respectively, reducing a major distortion through a bold move. Clearly, tariffs should follow the full cost recovery principle to encourage greater PSP and enhance efficiency in the allocation of resources. At the same time, the ability of the poor to pay for infrastructure services needs to be considered.

[6] In the first half of the 1990s capacity expansion by independent power producers helped attract major private investments and thereby eliminate power shortages in Southeast Asia. However, the financial crisis highlighted the risks of the then prevailing long-term take-or-pay contracts indexed to exchange rates, namely, the so-called triple mismatch. The currency mismatch resulted from the use of foreign exchange to implement projects generating revenues in local currency. After the currency meltdown in Indonesia, passing the foreign exchange risk on to consumers was impossible and the Government had to bail out the State Electricity Corporation (PLN). The maturity mismatch was attributable to the use of short-term loans for some capital-intensive projects with long service lives. And, finally, the capacity mismatch resulted from a conversion of the previous power shortages into significant surpluses, partly because of capacity overcontracting and partly due to the slowdown in demand growth in the aftermath of the crisis.

20. **Failure to Achieve Equity and Efficiency: Public Service Obligations.** Full cost recovery can only be achieved gradually over time. Even in the long term, low-income customers may not be able to pay for infrastructure services, and there are limitations on cross-subsidization by more affluent customer categories. The current situation differs from sector to sector, with no uniform PSO approach. Loss-making port and airport facilities are either cross-subsidized in SOE portfolios or left to line ministries to operate and finance from their budget.[7] In the power sector, the State Electricity Corporation (PLN) receives a major annual subsidy from the Government budget to offset losses in all consumer categories, for which the tariff is set below PLN's cost of supply. The subsidy was Rp12.5 trillion ($1.4 billion) in 2005 and budgeted at Rp28 trillion ($3.1 billion) for 2006. The very low tariffs for water supply result in the poor financial condition and high indebtedness of the regional water supply companies. The Government provides annual subsidies of about Rp20 billion ($2.2 million) for bus transport on 119 subdistrict routes, and about Rp76 billion ($8.4 million) for ferry transport on 64 river and interisland routes; these represent the so-called pioneer services. The Government also subsidizes railway operations and pioneer shipping and air transport services. Despite that, low economy-class railway fares impair the financial viability of the Indonesian Railway Corporation. In the telecommunications sector, Government Regulation 28/2005 allows 0.75% of revenues of private companies to be retained for subsidized rural services.

21. To achieve greater PSP and higher efficiencies in PSO provision, a consistent PSO framework is needed, including an implementation policy and sector-specific guidelines. While the public sector will continue to have an important role in delivering many noncommercial services, innovative approaches allowing PSP could include output-based aid that is explicit, targeted, and driven by the service provider's performance.

22. **Shallow Domestic Financing Modalities.** Banking plays a dominant role within the financial system, accounting for about 82% of overall assets. Capital markets have grown in importance, but long-term debt issuance has until recently been limited to Government bonds. The issuance of corporate bonds has grown gradually to just under $6 billion in 2005, with only a very small portion originating from SOEs operating in the infrastructure sectors. On the supply side, contractual savings institutions such as pension and insurance companies have traditionally invested predominantly in Government bonds or bank deposits. While the Government estimates that domestic financial institutions can meet about 20% of the infrastructure funding requirements, concerted reforms are needed to mobilize domestic resources of this magnitude. Domestic financing would help reduce the currency mismatch and the extent of Government guarantees. The Government needs to facilitate the development of local capital markets by enabling insurance firms and pension funds to finance infrastructure, deepening the bond market, strengthening credit-rating, establishing dedicated infrastructure funds, and allowing regional governments to borrow for infrastructure in local markets.

c. Other Constraints Impeding Infrastructure Development

23. **Weak Legal, Regulatory, and Implementation Framework for Land Acquisition.** Land acquisition problems have impeded several infrastructure projects, particularly toll roads. Until recently, land acquisition was governed by the old Basic Agrarian Law and Presidential Regulation (Perpres) 55/1993 on land acquisition for public infrastructure. While providing a legal basis, these documents failed to balance the need to protect social safeguards vis-à-vis the need for expeditious provision of land or right-of-way access needed for infrastructure development. As the cost of land is generally high, an effective mechanism is needed to finance land acquisition in a timely manner without leading to uncertainties and excessive speculation.

[7] Six SOEs operate 111 ports and 23 airports, leaving the remaining 606 noncommercial ports and 164 airports to be managed by the Ministry of Transportation.

In many countries, land acquisition for large infrastructure projects is done by the public sector as its contribution to the investment costs of PPP projects.

24. **Lack of Clarity Due to Regional Autonomy.** Decentralization, while devolving considerable authority and autonomy to local governments, has complicated matters related to infrastructure development. Responsibility for the provision of infrastructure services and the role of local government-owned enterprises (BUMDs) has not been clearly articulated. Local governments, with control over local infrastructure, have not been provided adequate funds and most lack the necessary capacity.

25. **Safety, Security, and Asset Maintenance.** Access and connectivity are vital in the Indonesian archipelago. Adherence to safety and security standards for various modes of transportation is equally critical. The Government recently began adopting safety and security norms, and establishing the necessary institutional mechanisms. In the road sector, maintenance gets varying levels of attention across the country, with national and provincial roads reasonably well preserved but district and urban roads in poor condition due to gross underspending on maintenance. Safety norms for road use and vehicle overloading are only slowly emerging, and enforcement is weak. Safety is also an issue for air and sea transportation, due to disparities in the adoption of safety norms across the country and ineffective enforcement.

d. Summary of Constraints

26. **Poor Governance and Resource Constraints.** In the aftermath of the 1997 financial crisis, four facets of governance that impede infrastructure development have emerged: (i) absence of sound PSP policies and framework; (ii) opaqueness in bidding, and corruption and rent-seeking during implementation affecting both public and private sectors; (iii) inequality in access to opportunities by the public and private sector; and (iv) weak cross-sectoral coordination. The impact of poor governance has been aggravated by the fiscal and other resource-related impediments affecting public and private investments in infrastructure: (a) declining institutional capacity for sector planning; (b) lack of focus on, and inadequate resources allocated to, project preparation; (c) lack of risk sharing; (d) lack of cost recovery, which threatens the financial viability of projects; (e) inability of the public sector to finance land acquisition; and (f) lack of long-term financial intermediation (Figure 1, page 9).

2. Lessons

27. The role of program lending as a vehicle for economic growth and poverty reduction is thoroughly examined in several studies leading to the following principal conclusions:[8]

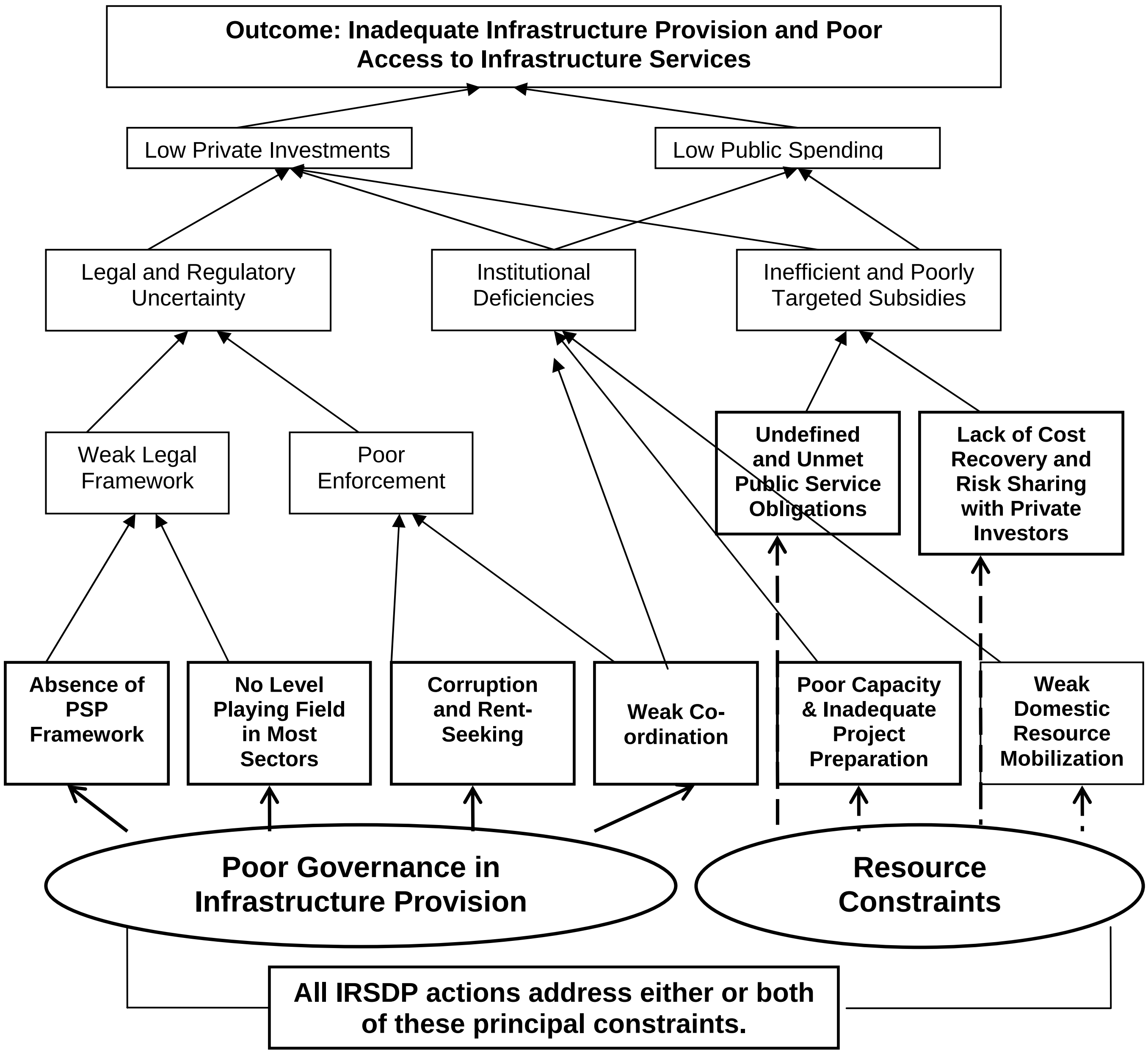
(i) Policy frameworks have often been complex and unrealistic.
(ii) A high degree of formal compliance with conditions does not necessarily lead to high quality compliance in terms of reform implementation and sustainability, nor is it a guarantee of the desired outcome and impact.
(iii) Political economy factors such as the commitment to, and timing of, reforms; extent of the underlying problems; appreciation by the public of the seriousness of these problems; and length of the government term are critical and should be effectively factored into the design of programs.

[8] ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Development Policy Support Program*. Manila (Loan 2228-INO), summarizes the studies and lessons. The relevant evaluation studies include (i) ADB. 2001. *Special Evaluation Study on Program Lending*. Manila; and (ii) World Bank. 2005. *Conditionality Revisited: Concepts, Experiences and Lessons*, ed. S. Koeberle, H. Bedova, et. al, Washington, DC.

(iv) Broader stakeholder participation is vital to obtain adequate buy-in and mitigate vested interests.

(v) Given the generally poor response of the private sector to mere adoption of policies and passage of laws, increased emphasis should be placed on the implementation of such policies and laws, institutional development, capacity building, and improvements in procedures and systems.

Figure 1: Constraints And Impediments Addressed by the IRSDP



IRSDP = Infrastructure Reform Sector Development Program; PSP = private sector participation.
Note: To achieve positive outcomes, the IRSDP focuses on the governance and the resources constraints shown in the bold boxes (para.26).

Source: Asian Development Bank staff

28. Taking into account these lessons, recent evaluation studies (footnote 8) recommend the following:

(i) Policy measures should focus on the main objectives of the program, and each action should be specific and directly related to the objectives.
(ii) Program design should allow not only the standard multiple tranche design, but also options with a single tranche, floating tranches, and a program cluster. Such flexibility is particularly important when actions beyond government control are necessary, such as legislative measures.
(iii) Reforms should be phased in and fully aligned with the country's broader medium-term development agenda.
(iv) Development partners should harmonize and coordinate their policy advice.

29. In general, progress in policy reform has been slow and gradual in Indonesia after the financial crisis due to political economy considerations, decentralization, and the complex structure of bureaucratic decision making. In the infrastructure sectors, reforms have been impeded by overlapping and conflicting responsibilities across a number of line ministries, agencies, and national and local government jurisdictions. Most of the findings of the special evaluation study are mirrored in an evaluation of the power sector restructuring program supported by ADB through a policy-based loan of $380 million and a technical assistance loan of $20 million, with cofinancing of $400 million from JBIC.[9] The program focused on sector regulation, unbundling, financial viability, PSP, and competition. The evaluation found that the implementation schedule was unrealistic and the program objectives too ambitious. On the positive side, the legal framework was established, first steps toward unbundling PLN were taken, PLN's financial viability was to a large degree restored, and conditions were created for continued PSP through postcrisis contract renegotiation with independent power producers. However, implementation took much longer than originally planned; release of the second tranche of the program loan was delayed by more than 2 years; and the objectives of introducing wholesale competition and divesting government majority stakes in the unbundled generation, transmission, and distribution companies were not achieved. The annulment of the Electricity Law 20/2002 by the Constitutional Court in December 2004 put further restructuring on hold. Overall, the program was rated as partly successful.

30. The current political economy factors generally bode well for IRSDP success. The Government has not yet reached the midpoint of its term. It has made accelerated infrastructure development a key pillar of its agenda and expressed the political will to proceed with necessary reforms, supported by a credible team of economic ministers. As the IRSDP is fully anchored on the Government's Infrastructure Policy Package, ownership of the relevant line ministries as well as oversight agencies such as the National Development Planning Agency (BAPPENAS), Coordinating Ministry of Economic Affairs (CMEA), and Ministry of Finance (MOF) is strong. The general public experiences the infrastructure bottlenecks and the poor quality of infrastructure services on a daily basis. Consequently, the majority support the reforms, as demonstrated by their acceptance of the steep oil price increases in March and October 2005. Nevertheless, the reform agenda is broad and challenging as it covers all infrastructure sectors, and vested interests oppose parts of it. This underlines the need for flexibility in reform implementation.

31. Based on these considerations, a program cluster modality is proposed for the IRSDP. The program cluster will consist of three single-tranche subprograms anchored on the Government's Infrastructure Policy Package. The policy actions are allocated to three phases each of 21 months: January 2005–September 2006 for subprogram (SP) 1, October 2006–June 2008 for SP2, and July 2008–March 2010 for SP3. The flexible program structure helps deflect

[9] ADB. 2004. *Program Completion Report on the Power Sector Restructuring Program in Indonesia*. Manila.

criticisms that the reforms are a result of external pressure. The medium-term reform agenda and its timing will be reviewed in light of the accomplishments of SP1 and possible changes in the policy environment, and modified if necessary under SP2 and SP3. Appendix 3 presents the Government's development policy letter outlining its commitment for the IRSDP, along with the policy matrix, which outlines the IRSDP structure. Appendix 4 summarizes important outcomes accomplished thus far as part of SP1.

3. External Assistance

32. Traditionally, ADB, JBIC, and the World Bank have been the Government's principal development partners in the infrastructure sectors. The overall IRSDP design and implementation of reform measures thus far under SP1 have benefited from close cooperation of the three institutions. In addition, the development partners and the Government have taken into account the views and concerns of the private sector.[10] Close coordination among the development partners, including the Government of Japan (through the Strategic Investment Action Plan) and the Australian Agency for International Development, has ensured that the combined resources are effectively utilized. Particularly noteworthy is the efficient use of TA resources for capacity development, risk management, and preparation of PPP projects. The development partners, in collaboration with other stakeholders, have also focused on improving governance and anticorruption in infrastructure provision. At the same time, the fact that the IRSDP is founded on the Government's own policy agenda helps reduce concerns about external pressures for reform. Based on the joint work as well as given the overall benefits of harmonizing development support, the Government of Japan and the World Bank are considering cofinancing the IRSDP; building on the earlier joint financing by ADB and JBIC in the power sector (2001); and the parallel financing from the World Bank, Japan and ADB for the Development Policy Support Program (2005). Appendix 5 contains the development partner coordination matrix, outlining support in areas related to the IRSDP.

4. Rationale and Linkage with Other ADB Assistance

33. IRSDP design and implementation have been closely coordinated with ongoing and planned ADB programs and projects. ADB is adopting a dual-track approach to enhance the linkage and synergy between cross-cutting macroeconomic reforms and deeper sector reforms.[11] The measures supported under the IRSDP facilitate ADB provision of significant development assistance to Indonesia through both public and private sector operations. Two major private sector operations of ADB in the gas sector were approved recently, increasing ADB's direct support for private sector development in Indonesia. The IRSDP reforms will enhance sustainability of the recent and planned investments by strengthening the policy and regulatory framework, particularly in the toll-road, gas, and power sectors. Lessons from the design and implementation of public and private sector projects will feed into reforms in subsequent phases of the IRSDP. The new country strategy and program for Indonesia, with its focus on improving the investment climate, envisages deeper support for private sector development, through a stronger linkage between ADB's public and private sector operations. In addition, the IRSDP will act as a vehicle to help implement important cross-cutting initiatives being pioneered by ADB in the region such as the Clean Energy Initiative and the Water Financing Program.

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[10] For example, two power sector meetings—in Tokyo in March 2004 and in London in May 2004—were organized with support from ADB, JBIC, and World Bank. The concerns raised by the private sector related to government guarantees for power sector investment, sanctity of power purchase agreements, future structure of the power sector, retail electricity tariffs, power sector planning and regulation, and foreign exchange risk mitigation.

[11] ADB.2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Development Policy. Support Program.* Manila, (para. 7, Loan 2228-INO), outlines this dual-track approach.

III. THE PROPOSED SECTOR DEVELOPMENT PROGRAM

A. Impact and Outcome

34. The IRSDP will improve the investment climate and support timely realization of the Government's medium-term macroeconomic goals, in particular achieving average annual GDP growth of 6%–7% during 2005–2009 by enhancing infrastructure provision and access. This will enable the Government to reduce poverty and boost job creation. The expected outcome of the IRSDP is accelerated infrastructure development through large-scale PSP and mobilization, and allocation of additional public sector resources.

B. Important Features

35. The IRSDP has a number of noteworthy features. First, its overall design is fully in line with the Government's medium-term development growth vision, as articulated in the RPJM, and the Government's infrastructure reform agenda, as formulated in the Infrastructure Policy Package. Second, designed as a program cluster consisting of three subprograms, the IRSDP provides the necessary flexibility to an emerging middle-income country like Indonesia that is going through democratic and political transition to build consensus for reforms among stakeholders with competing interests. It also ensures continuity of reforms resulting in a natural progression from actions to desired outcomes.

36. Third, the IRSDP helps address investment climate impediments, a major area of concern in Indonesia. The program supports measures to enhance investments in infrastructure provision, including well-defined sector policies and blueprints outlining the medium and long-term priorities; clear legal and regulatory framework that results in equal access and conditions and independent regulatory arrangements over the medium term; efficient risk-sharing mechanisms to enable greater PSP; strengthened fiduciary management in determining public sector investments in PPP projects; and improved governance and transparency in the selection of private sector partners to minimize the risks of corruption that has afflicted investments in the past in Indonesia. The IRSDP's focus on accelerating infrastructure provision will in turn promote and facilitate other business investments. Several surveys[12] show that the inadequate provision and poor quality of infrastructure services, and disparities in service coverage are major impediments in increasing domestic and foreign investments in Indonesia. Fulfilling PSOs is a key cross-cutting area that has an indirect impact in terms of attracting investments in the future. As the Indonesian economy grows and investments increase, the widespread disparities in development across the country must be addressed. Reducing potential discontent among the poor and other vulnerable segments of the population is particularly relevant in underserved areas with significant natural resource potential, where investments may initially benefit only a few segments of the local population before the benefits can reach the communities at large.

37. Finally, in a thematic sense, the principal focus of the IRSDP is to strengthen governance and alleviate resource constraints in infrastructure provision. Box 2 highlights the focus on governance.

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[12] ADB. 2005. *Indonesia Investment Climate Survey*. Manila; World Bank. 2006. *Cost of Doing Business*. Washington, DC.

Box 2: IRSDP Focus on Governance in Infrastructure Provision

The IRSDP is a comprehensive medium-term reform program that addresses a range of issues aimed at widespread adoption of good governance. The IRSDP supports the formulation and/or adoption of the following:

- Legal and regulatory framework that provides for transparent and competitive bidding to select private sector partners, even for unsolicited proposals
- Risk-sharing framework that focuses on project quality and transparency in deciding on the type and amount of Government support, and that stipulates that such support can be provided only if indicated in the bidding documents
- Gradual dismantling of state-owned enterprise monopolies and creation of a level playing field in as many sectors as feasible
- Sector-specific measures to deal with corruption, such as adoption of standard bidding documents and initiation of e-procurement in the road sector
- Preparation and transaction execution in a transparent manner for about 25–30 model PPP projects to demonstrate the merits of the new private sector participation and risk management frameworks

IRSDP = Infrastructure Reform Sector Development Program; PPP = public-private partnership

C. The Program Loan

1. Impact and Outcome

38. The IRSDP policy framework is founded on three reform pillars:

(i) Strategic cross-sectoral reforms will result in

(a) improved policy, legal, and institutional framework for greater PSP anchored on good governance principles;
(b) a well-structured risk management framework that promotes PSP;
(c) accelerated mobilization of domestic long-term financial resources for infrastructure development, and establishment of innovative funding mechanisms to finance PPP transactions; and
(d) a streamlined regional autonomy framework, clearly delineating functional responsibilities of national and local governments in infrastructure provision.

(ii) Sector-specific policy, legal, and institutional reforms[13] will lead to

(a) improved financial soundness and sustainability of infrastructure services through full cost recovery;
(b) greater competition that benefits consumers through improved service delivery and lower tariffs;
(c) independent regulatory structures that are distinct from the contracting and operating functions;
(d) equal access and opportunities for all participants, and prevention of abuse of natural monopoly rights; and
(e) fulfillment of the PSOs of infrastructure service providers, in line with the Government's poverty reduction objectives.

[13] The sector coverage of the IRSDP includes transportation (roads; ports and airports; and railways); power; oil and gas; telecommunications; and water supply and sanitation.

(iii) Facilitation of preparation and execution of well-structured project transactions will result in sound model infrastructure projects that can be replicated.

2. Policy Framework and Actions

39. The IRSDP policy framework and how the principal constraints and impediments will be addressed are shown in Figure 1. Table 2 highlights key program outputs and outcomes. A list of the main policy actions, together with the accomplishments under SP1, is in Appendix 4. A more detailed discussion of the actions and outputs follows.

Table 2: IRSDP Framework Summary

Principal Constraints		IRSDP Program Components	Selected Program Outputs and Outcomes	
			Subprogram 1	**Subprograms 2 and 3**
		Strategic Cross-Sectoral Reforms	• PSP framework that ensures competitive selection of project sponsors • Transparent risk-sharing decisions • Streamlined land acquisition framework	• Fully functional guarantee fund
• Poor Governance	Addressed through	Sector-Specific Reforms	• Updated sector plans • Regulatory and contracting bodies for toll-road and gas projects • Cost recovery in road and water supply projects	• Equal access and opportunities for all players in all sectors • Independent regulatory authorities in the toll-road, gas, water supply, and telecommunications sectors • Rationalized subsidies and transparent PSOs
• Resource Constraints		Facilitation of PPP Project Transactions	• Ten candidate model PPP projects worth up to $4.5 billion identified, and preparation started	• Selected model PPPs contracted out and construction started • Bidding for a significant number of further PPPs • Total infrastructure investments increased from about 2% to 5% of GDP by 2009
			• Project development facility established, and project preparation and transaction execution support provided for at least 10 national and about 40 decentralized PPP projects	

GDP = gross domestic product; PPP = public-private partnership; and PSO = public service obligation.
Source: ADB staff.

a. Strategic Cross-Sector Reforms

40. **Legal and Institutional Framework to Promote PSP**. Based on the IRSDP policy dialogue, the Government issued Perpres 67/2005 on *Cooperation between the Government and Business Entities in the Provision of Infrastructure* in November 2005 to provide a more comprehensive PSP framework and thereby establish a clear and predictable environment within which private investors will operate. Perpres 67/2005 defines two forms of PSP: partnership and licensing agreements. These agreements should specify, among other things,

the project scope, period of partnership/license, implementation/operation warranty, tariff and tariff adjustment mechanism, risks and obligations, performance standards, dispute resolution, and supervision method. PPP projects can be identified and prepared either by the Government or the private sector, but the sponsors must be selected through open and transparent bidding. Perpres 67/2005 describes in detail the rules and procedures for the bidding process, and calls for tariffs to be set at full cost-recovery. If this exceeds the affordability of consumers to pay, the Government must compensate for the difference with a PSO subsidy. Perpres 67/2005 recommends that risks be allocated to the party that is best able to manage and control them.

41. **Strengthening Institutional and Coordination Arrangements for PSP.** Perpres 42/2005 issued in May 2005 strengthens the ability of the interministerial National Committee for the Acceleration of Infrastructure Development (KKPPI)[14] to fulfill its role in formulating infrastructure strategies and policies, coordinating and supervising the implementation of these strategies and policies by the line ministries and local governments, formulating PSO policy for infrastructure services, and solving problems that impede infrastructure development by the public and private sector. CMEA Regulation 1/2006 issued in May 2006 outlines the organization structure of the KKPPI Secretariat and describes its tasks, which include resolving cross-sectoral issues, preparing and updating medium- and long-term infrastructure investment plans, reviewing and prioritizing requests for Government support for PPP projects, and conducting stakeholder consultations. The secretariat is headed by the deputy minister for infrastructure and regional development in CMEA (in charge of administrative and private sector coordination) and the deputy minister for infrastructure affairs in BAPPENAS (in charge of technical support). The KKPPI Secretariat needs sustained capacity building and advisory support to fulfill its responsibilities.[15]

42. For the day-to-day coordination and management of PPP transactions, a network consisting of a central PPP unit under the KKPPI Secretariat and PPP nodes in the line ministries is being developed.[16] With the execution of PPP transactions devolved to the line ministries and contracting agencies, the central PPP unit will be responsible for ensuring policy consistency, quality control, and transparency by establishing standards and principles that all transactions must follow, and by monitoring the execution for compliance. Given the massive investment needs against limited capital resources, the unit will prioritize PPP projects according to their development impact and readiness for implementation. Other tasks include assisting line ministries and local governments in identifying, preparing, and implementing PPP projects; reviewing project evaluation carried out by the PPP nodes; evaluating requests for Government support needed for PPP projects; coordinating such support with MOF; publishing status reports on PPP projects and disseminating other relevant information; preparing guidelines and manuals for PPP projects; and building capacity in the PPP nodes.

43. To ensure adequate information on infrastructure development among the various stakeholders, the Consolidated Indonesia Infrastructure Forum was established in 2005, initially as a unit under CMEA with financial support from the World Bank. The forum is intended to become an independent stand-alone self-financing organization. The forum is to act as an effective bridge between the KKPPI and the private sector, to ensure common understanding.

[14] The KKPPI, which reports directly to the President, is cochaired by the coordinating minister of economic affairs and the chairperson of BAPPENAS, the latter acting as the executive chair. Its members include the ministers of finance, home affairs, energy and mineral resources, public works, transportation, communications and informatics, and state-owned enterprises, as well as the cabinet secretary.

[15] ADB is providing capacity building for the BAPPENAS part of the KKPPI Secretariat through a TA grant (ADB. 2005. *Technical Assistance to the Republic of Indonesia for Support for Infrastructure Development.* Manila [TA 4728-INO for $2 million]). The World Bank has been supporting the CMEA part of the KKPPI Secretariat and the line ministries through its $17.3 million Private Provision of Infrastructure Technical Assistance loan.

[16] The Private Provision of Infrastructure Technical Assistance loan has been tapped for designing and establishing the central PPP unit and its network.

Given the importance of such stakeholder consultations, the forum needs to be fully operationalized as soon as possible.

44. **Adoption of a Risk Management Framework**. The Government is developing a risk management framework for the infrastructure sectors as an instrument for assessing, pricing, monitoring, and managing contingent liabilities that arise from selective guarantees for PPP projects against risks related to policies and performance of the Government and its agencies. In view of the links to its existing budgeting, fiscal accounting, and debt management systems, MOF has been playing an important role in developing and implementing the framework. In October 2005, the minister of finance issued Regulation 518/2005 on the establishment of the Risk Management Committee, which specified its structure and principal tasks. Apart from making recommendations on the appropriate risk management policy, the committee was to perform the risk management function before the creation of a permanent Risk Management Unit in MOF's new Fiscal Policy Office. The risk management function involves examining requests for Government support for PPP projects submitted by the contracting authorities, screened by the PPP nodes in the line ministries, reviewed and prioritized by the KKPPI Secretariat with the help of the central PPP unit, and endorsed by the KKPPI; setting the parameters and targets for PPP agreements; and monitoring performance of PPP projects during their operation. Support for the Risk Management Unit will be provided through the TA attached to the IRSDP (para. 94).

45. In May 2006 the minister of finance issued Regulation 38/2006 on the risk management policy to ensure that risks of individual PPP projects are appropriately allocated between the public and private sectors, and that the Government's overall exposure is well managed. The dual objective of the policy is to support infrastructure development while maintaining fiscal sustainability of the Government budget. The new regulation describes the types of risks the Government may consider sharing (those related to political events, project performance, and demand), the main principles for providing such support (legality, project quality in terms of technical and financial feasibility, fiscal prudence in terms of total exposure and annual budget, and transparency), and approval procedures. The MOF regulation was complemented in June 2006 by CMEA Regulation 4/2006 on the evaluation procedure for projects requiring Government support. While reiterating the project quality, fiscal prudence, and transparency principles, this regulation outlines the roles of the KKPPI, its secretariat, and the central PPP unit in the evaluation; and specifies in detail the documentation needed and criteria to be met, such as the feasibility study, environmental impact analysis, socioeconomic benefit-cost analysis, risk analysis, bidding documents (including draft concession agreement), and the project's compatibility with the RPJM, sector strategic plan, and regional spatial plan. As to the transparency principle, the regulation stipulates that requests for Government support must be submitted before bidding.

46. **Supporting Land Acquisition**. Intensive stakeholder review and feedback, including comments from international investors at the February 2006 Infrastructure Forum, resulted in the adoption of Perpres 65/2006 in June 2006 to amend Perpres 36/2005.[17] Together, the two regulations have the potential to move the Government's policies on land acquisition closer to internationally accepted principles on involuntary resettlement, particularly with regard to provisions on the use of market prices and recognition of nonphysical losses. The National Land Agency has drafted implementing regulations, which provide for both aspects. For projects serving public interest, expropriation is allowed after 120 days if no agreement is reached with landowners. The period for negotiations excludes the time required for identification, valuation,

[17] Replacing Perpres 55/1993 on land acquisition for public infrastructure and providing for independent valuation of property to reduce opportunity for speculation; expanding the definition of public interest to areas such as piped water, power transmission lines, and sanitary landfills; and clarifying the period of negotiations before any recourse by expropriation can be sought.

and notification of the asset owner. While gaps still exist in terms of ADB policy requirements on livelihood restoration, consultation, grievance redress, and rights of squatters, the Government is considering how to address these through the implementing regulations. In addition, some of these gaps may be addressed in planned amendments to the Basic Agrarian Law. As demonstrated by the unsuccessful bidding for several toll-road projects, investors are unwilling to bear the land acquisition risk. Therefore land acquisition must be completed prior to bidding. MOF is finalizing its plans on appropriate institutional arrangements for financing land acquisition from the budget, with reimbursement from investors once their projects are completed and yield revenue.

47. **Diversifying and Strengthening Financing Modalities and Mechanisms**. MOF has prepared a policy paper outlining measures needed to mobilize resources through various modalities and mechanisms to provide financing for PPP projects. The paper covers the entire spectrum of financing needs, from project preparation to implementation, for both public and private investments and guarantees: (i) PDF for preparing national and decentralized infrastructure projects; (ii) a PPP infrastructure financing fund to help meet the public sector portion of PPP transactions, including land acquisition and other upfront investments; (iii) a guarantee fund to provide backing for government support; and (iv) an Indonesia infrastructure fund to offer project financing to the private sector. Given the weaknesses in project preparation that have impeded execution of PPP transactions, establishment of the PDF merits top priority.

48. **Addressing Intergovernmental Coordination Issues**: The issues related to intergovernmental fiscal relations, local government borrowing (including onlending and on-granting of foreign loans by the central Government to local governments), and workout of local government debt arrears are being addressed by strengthening the relevant legal framework.[18] These efforts have been supported by two policy-based operations of ADB[19] and the World Bank,[20] approved in late 2005. As part of the IRSDP, the Government has drafted a regulation clarifying national and local government responsibilities in infrastructure provision, operation, contracting, and regulation. The Government has also drafted a law on BUMDs. Under the new legal framework on decentralization,[21] local governments may issue bonds in local currency. However, the financial soundness of local governments needs to be thoroughly assessed, and an appropriate legal framework adopted that clearly outlines the criteria for central Government approval and recourse, besides credit-rating and other oversight requirements.[22]

b. Sector Policy, Legal, and Institutional Reforms

49. **Roads**. The new Road Law 38/2004 and the subsequent Government Regulation 15/2005 on Toll Roads reformed the legal framework and are facilitating greater PSP.[23] They have unbundled the sector by separating the regulatory functions from the main SOE, Jasa Marga; calling for the establishment of a new regulatory body; ending Jasa Marga's monopoly on toll-road development; and allowing private investors to bid for new build-operate-transfer or concession projects in competition with Jasa Marga. In August 2005, the Ministry of Public Works (MPW) issued Decree 374/2005, which enables the toll-road tariffs to be set on the basis

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[18] Enactment of the Law on Regional Fiscal Balance 33/2004, and ongoing revisions to Government Regulation 107/2000 and Ministerial Decree 35/2003.

[19] ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Local Government Finance and Governance Reform Sector Development Program*. Manila (Loan 2192–INO for $300 million).

[20] Second Development Policy Loan, approved by the World Bank on 15 December 2005 for $400 million, and cofinanced by ADB's Development Policy Support Program loan (footnote 8).

[21] Law 32/2004 on Regional Autonomy and Law 33/2004 on Regional Fiscal Balance.

[22] ADB is providing TA to undertake a preliminary assessment of selected local governments, and to draft the relevant legal framework.

[23] To date, the private sector has been involved in the development of only 24% of the 600-km toll road network.

of a bidding process. At the same time, tariffs for existing toll roads were increased by 15%–50% to ensure financial sustainability of their operation. To complete the legal framework, MPW has been issuing a series of implementing regulations. Road Law 38/2004 will be complemented by the new Law on Road Traffic and Transportation, drafted by the Ministry of Transportation (MOT) and submitted to Parliament, providing many opportunities for PSP in transport services, transport infrastructure such as bus terminals and parking, and support services such as vehicle inspection.

50. As stipulated by the new legal framework, the Indonesian Toll Road Authority was established in October 2005. Its responsibilities include developing business plans and feasibility studies for toll-road projects; conducting bidding, facilitating land acquisition, and recommending tariffs for such projects; and supervising implementation of toll-road concessions. The authority, which reports to the minister of public works, comprises a chairperson and four members from the Government, road association, universities, and other stakeholders. To ensure complementarity of toll roads with other parts of the road network, the toll-road authority works closely with MPW's Directorate General of Highways. The short-term challenge is to fully operationalize the authority. In the medium term, a separation of its contracting and regulatory functions, and making the latter fully independent of MPW, should be considered.[24]

51. Institutional capacity in the road sector is still weak in some aspects. While national asset management capacity is being strengthened, capacity building for development planning and operation and maintenance is needed. Regional agencies vary considerably in capacity and performance, and interagency coordination is weak. Heavy vehicle overloading is prevalent, road preservation costs are increasing significantly, and road safety is poor. The implementation of road works is often expensive and of low quality, and collusion among contractors is a problem. The business practices and performance of national agencies and the construction industry need to be improved and capacity of the regional agencies built up. Regulatory enforcement to reduce vehicle overloading needs strengthening and a comprehensive road safety program implemented. MPW, together with MOT and with assistance from the World Bank, is preparing two initiatives in these areas: a pilot road safety program in Semarang and pilot testing of performance-based contracts for road maintenance, including vehicle load control, in central Java. To increase transparency and reduce opportunities for corruption, MPW has adopted standard bidding documents and is developing an e-procurement system for all road contracts. Moving forward, a comprehensive action program of anticorruption measures in the areas of procurement, transparency and accountability, auditing, and human resources will be formulated and implemented under SP2 and SP3.

52. To put the financing of road maintenance on a self-sustained basis, restructuring of vehicle-related taxes needs to be considered. The restructuring should lead to a system of road-user charges that ensures full recovery of the necessary road preservation costs, and reflects actual road usage and the contribution of various vehicle categories to these costs. In particular, charges for heavy vehicles should be related to their load capacity and road-damaging effects. In the medium term, the establishment of a transparent accounting mechanism such as a road fund should be considered. Measures are also necessary in the medium term that separate the operator and regulatory functions, and make the latter independent of MPW, which sets overall sector policy.

[24] Such independence can be achieved by giving the regulatory body statutory authority and ensuring that it has adequate technical expertise, reports to the President of Indonesia, has no financial stake in any sector operator, is financially autonomous through funding from levies on the regulated industry, is headed by commissioners appointed for fixed terms and on the basis of transparent selection criteria, and has appropriate stakeholder representation.

53. **Ports and Airports**. The legal and regulatory framework needs to be revised to end the monopolies of the four SOEs in the port sector and two SOEs in the airport sector, as well as their multiple roles of landlord, regulator, contracting authority for the provision of port/airport services, and operator. In addition, the creation of a separate provider of air traffic services should be considered. Significant progress has already been made in revising the legal and regulatory framework. Presidential Decree 5/2005 on Empowering Domestic Shipping Industry promotes the separation of regulatory and operational functions in ports, and encourages competition among operators within and between ports. MOT has completed the drafting of new laws for sea transport and aviation, and submitted them to Parliament. It is important that the new laws, including the subsequent implementing regulations, provide for such sector restructuring. In particular, the legal framework should allow the establishment of true landlord port and airport structures where landlords have no direct financial stake in any service providers, and should clarify the roles and responsibilities of local governments.

54. The creation of landlord structures where operating concessions can be competitively tendered with no conflict of interest from the landlord will require restructuring the six SOEs to focus on either the landlord or operating role. As each of these SOEs manages a group of loss- and profit-making ports/airports, such restructuring will also help in efficiently managing the PSOs. In the airport sector, separating air traffic services will significantly reduce SOE revenues. Tariff adjustments to reflect cost recovery will help offset this reduction. Regulation of tariffs, safety and service standards, and licensing can continue to be the responsibility of MOT, but in the medium term, the creation of independent regulatory bodies should be pursued, with MOT in charge of policy making, planning, and coordination.

55. **Railways**. MOT has completed the drafting of a new railway law and submitted it to Parliament. If enacted in its current form, the new law will end the monopoly of the Indonesian Railway Corporation in operating rolling stock and maintaining infrastructure, and allow private service provision without forming a joint venture with the railway corporation. To succeed in competition for the market with private sector service providers, the corporation will have to improve its management and operation. In the medium term, ensuring equal conditions for all service providers by establishing an independent regulatory body is important. Transparent tariff setting and PSO arrangements will also go a long way in encouraging PSP.[25]

56. **Power**. To remove the legal uncertainty caused by the ruling of the Constitutional Court in December 2004, which automatically led to reenactment of the previous Electricity Law 15/1985, Government Regulation 3/2005 on Electricity Procurement and Utilization was issued in January 2005, followed by two ministerial decrees. While giving the principal authority for power supply to PLN, the regulation and decrees allow purchase of electricity by PLN from independent power producers. This is an interim solution until a new law is in place, for which public consultations are being held by Parliament. The new law, while respecting the Constitution, should retain the spirit of the annulled law, and be quickly followed by implementing regulations. Given the controversy and uncertainty caused by the ruling of the Constitutional Court, stakeholder consultations are essential for reaching a consensus on how to reduce PLN's monopoly and increase competition in the longer term, while retaining control of the sector through stronger planning and regulation. Nevertheless, as PLN will continue to dominate the sector in the foreseeable future, its institutional capacity in areas such as project planning and implementation, financial management, and corporate governance should be strengthened. The planned PLN corporate restructuring study will support this effort.

[25] At present, the passenger fares for economy class travel are set by MOT based on the ability to pay, with the difference to the actual cost to be reimbursed to the Indonesian Railway Corporation, which implements this PSO policy, while other passenger fares and all freight fares can be set by the corporation subject to MOT's endorsement.

57. Restoring PLN's financial viability is crucial for enhancing its creditworthiness. If independent power producers and their financiers have doubts about PLN's ability to pay their bills, the demand for Government guarantees against this off-take risk will rise and the additional installed capacity requirements may not be met. Originally, the Government planned to increase the average electricity tariff by at least 15% in early 2006. However, because of the negative impact of the previous fuel subsidy reductions and interest rate increases on inflation and economic growth, and the Government's concern about the likelihood of major public protests, the tariff increase has been deferred. The Government recognizes that cost recovery must be achieved once the political and macroeconomic conditions allow. Its medium-term strategy is to combine tariff increases with cost-saving measures, such as the coal-fired power plant program to displace oil-based generation, as well as with improvements in PLN's efficiency, such as a reduction in the transmission and distribution losses from 11.5% in 2005 to below 10%. Once full cost recovery is achieved, the tariff issue should be depoliticized[26] by developing a rational tariff-setting mechanism that maintains the recovery, and delegating responsibility for its application to an independent regulatory body. In the interim, the Government is willing to provide assurances for new independent power producer projects indicating that the Government will ensure that PLN can meet its PSOs. This would be a departure from the earlier open-ended practice of the Government commitment to ensure PLN meets its power purchase agreement obligations. The IRSDP will support the development and implementation of a fiscally sound system in this area.

58. When increasing electricity tariffs, the impact on the poor must be cushioned. The current lifeline rate system[27] may be too generous in its coverage as more than half of PLN's 33 million customers accounting for almost 30% of PLN's electricity sales benefit. The system, including connection fees, should be reviewed to determine whether better targeting and protection of the poor are necessary by narrowing customer groups benefiting and, at the same time, reducing the lifeline rate.

59. **Oil and Gas**. The Government has given high priority to gradual removal of fuel subsidies, as they have posed a heavy burden on the budget,[28] disproportionately benefited the middle class and the rich,[29] and distorted the energy mix. Given the political sensitivity of this issue, the Government conducted a comprehensive socialization campaign and explained the rationale for, and unavoidability of, the gradual subsidy removal before increasing the domestic prices of oil products in February/March 2005 by an average of 49%.[30] Despite the major price increases, the subsequent unfavorable movement of world market prices widened the gap again. MOF projections showed that the fuel subsidy would rise from the $8.2 billion allocated in the revised 2005 budget (18% of the total government expenditure), to almost $15 billion (33%), crowding out expenditures for social sectors and infrastructure. As this development was clearly unsustainable and negatively affected the rupiah, the Government took two bold actions. In July–August 2005, prices for industrial users, accounting for 37% of total consumption, were brought to international levels, and in October 2005 after intensive socialization efforts, prices of the remaining oil products were raised by an average of 126%.[31] To mitigate the social impact

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[26] Government Regulation 3/2005 upholds the principle that electricity tariffs are set by the President of Indonesia based on a recommendation of the minister of energy and mineral resources.

[27] The lifeline rate of about $0.018/kWh is applicable to small residential consumers with a capacity of less than 450 volts-ampere, social institutions, small businesses, and small industries, for the first 30 kWh of their monthly consumption.

[28] In the 2004 budget, i.e., before the sharp rise of international oil prices, fuel subsidies were almost equivalent to the allocation for education and health, and more than twice as high as the allocation for roads and irrigation.

[29] Only about 6% of Indonesian households have cars, and only a third have motorcycles.

[30] By 27% for automotive diesel oil, 33% for gasoline, 39% for industrial diesel oil, 44% for kerosene used by industry, and 104% for marine fuel oil. For social reasons, the price of kerosene used by households was kept unchanged.

[31] By 105% for automotive diesel oil, 88% for gasoline, and 186% for kerosene, bringing the prices of these products to 77%, 80%, and 33% of the then prevailing international levels.

of these unprecedented measures,[32] the Government announced a major package of direct subsidies to the poor.[33] The Government also made clear its intention to complete the fuel subsidy removal during 2006–2007 and let domestic oil prices follow international prices.

60. Given its large reserves, natural gas can play a much more important role domestically. The recently issued Perpres 5/2006 on National Energy Policy stipulates a minimum share of 30% for natural gas in Indonesia's energy mix by 2025, compared to less than 20% for oil. In response to the Constitutional Court's ruling on oil and gas pricing, and the minimum gas allocation for the domestic market, the Ministry of Energy and Mineral Resources drafted the necessary amendments to the implementing regulations for Oil and Gas Law 22/2001, setting the domestic market obligation for gas producers at 25%. Another impetus to the domestic use of gas will come from the new Energy Law, which aims to increase access to energy and ensure energy security through diversification, conservation, and public participation. Investments in the country's large reserves of coal-bed methane have been limited due to lack of policy and legal clarity on extraction and sale or the resource. A policy and operational guidelines for coal-bed methane exploration and production are needed.

61. The current dual role of regulator and contracting authority played by BPH Migas in the downstream part of the sector may raise concerns among operators about its objectivity in resolving contractual disputes. The division of contracting authority for the upstream and downstream business between BP Migas and BPH Migas may lead to inconsistencies in the planning and implementation of upstream and downstream projects. Consequently, current arrangements should be reviewed in the medium term, with a view to creating a single regulatory body and a single contracting agency, and ensuring that the former has no links to the latter and is fully independent. Apart from managing tariffs prescribed by contract or determined by the market, the new regulatory body should take over some other regulatory functions currently exercised by the Ministry of Energy and Mineral Resources, such as issuing licenses and setting service standards.

62. **Telecommunications**. This infrastructure sector is more advanced in terms of reforms than other sectors. The two major enterprises with state ownership—Telkom and Indosat—are listed at the Jakarta and New York stock exchanges, the Indonesian Telecommunications Regulatory Body[34] is operational and after stakeholder consultations, the Ministry of Communications and Informatics issued Regulation 8/2006 on interconnection providing for a move from revenue sharing to a cost-based approach for tariff setting. Looking forward, the sector blueprint needs to be updated taking into account achievements in PSP, lessons, and technological advances. To move from the current duopoly to full competition and thereby encourage higher investments by the private sector, business opportunities need to be opened for fixed-line long-distance and international connections. This will require the design of a new industry structure and restructuring of the current licensing system. Finally, a PSO policy is needed to help accelerate the expansion of fixed-line services, particularly in rural areas.[35]

63. **Water Supply and Sanitation**. IRSDP supports the formulation of policies on community and institution-based provision of water supply and environmental sanitation

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[32] A 12% oil price increase in 2000 was followed by a 30% increase in 2001 and a 22% increase in 2003. The 2003 increase was partly rolled back by the previous administration because of public discontent.

[33] The package consists of quarterly payments of Rp300,000 to an estimated 15.6 million households with a monthly per capita income of less than Rp175,000.

[34] Chaired by the director general of post and telecommunications, of the Ministry of Communications and Informatics, the regulatory body has six other members, and is funded from the ministry's budget. Apart from being involved in this regulatory function, the Directorate General of Post and Telecommunications is in charge of policy making and business license issuance.

[35] The recent Government Regulation 28/2005 allows retaining 0.75% of revenues of telecommunication companies for this purpose.

services to more effectively address access and quality issues in service delivery.[36] The Water Resources Law 7/2004 and the subsequent Government Regulation 16/2005 on Water Supply have established a major part of the necessary legal framework by clarifying the terms for PSP,[37] ending BUMD monopolies, eliminating the need for local parliament approval of water tariff increases, and calling for the establishment of the National Water Regulatory Agency under MPW.[38] Despite its name, the agency is basically an advisory rather than regulatory body. Its main responsibilities include helping formulate sector policy and strategy, setting operational standards for water supply, setting and evaluating service standards and performance of the regional water supply companies (PDAMs), and making recommendations on involving cooperatives and the private sector in water supply. As water supply falls under the authority of the fully decentralized district governments, the Government's vision is to strengthen the role of the National Water Regulatory Agency. The institutional arrangements for regulation will be reviewed and strengthened under SP2 and SP3, parallel to the issuance of the remaining implementing regulations related to national water resources policy, national water resources board, water resources management, water resources business, rivers and lakes, swamps, dams and reservoirs, groundwater, water quality management, and irrigation.

64. To ensure operational efficiency and financial viability of PDAMs, their commercialization and corporatization need to be pursued through enhanced management autonomy, technical capacity building, cost-recovery tariffs, improved revenue collection, better financial management and accounting, unaccounted-for-water reduction, stronger customer orientation, mergers of small nonviable PDAMs, and service coverage expansion. A system of transparent PSO subsidies targeting the poor in urban and rural areas is needed as part of expanding service coverage. Given the high indebtedness of most PDAMs, financial restructuring through the conversion of their long-term debt into government equity and offsetting receivables from local governments with repayments due to MOF is essential. The Government is preparing several restructuring programs comprising over 40 PDAMs.[39] Under SP1, detailed appraisals have been completed for five PDAMs, which will receive implementation support during SP2. If the pilot program proves successful, the Government is committed to country-wide expansion.

c. Model Public-Private Partnership Projects

65. At the IIS in January 2005, the Government offered 91 projects totaling $22.5 billion to the private sector,[40] but the expectations raised by this major offering have not yet been met. So far prequalification and bidding have been undertaken for two batches of toll roads comprising a total of 17 projects, three gas pipeline projects, and one power project; prequalification is ongoing for another six power projects. Participation in the bidding has been generally low.

[36] ADB's policy dialogue with the Government has been guided by the framework developed in ADB. 2003. *Asian Water Supplies*. Manila.

[37] PSP can take the form of a cooperation agreement with the concerned regional water supply company or a license granted by the concerned local government.

[38] Under ADB. 2001. *Technical Assistance to the Republic of Indonesia for the Regulatory Framework for Private and Public Water Supply and Wastewater Enterprises.* Manila (TA 3761-INO), various regulatory framework options were discussed extensively with central, local, and private stakeholders. In view of the decentralized structure, a consensus emerged to set up a two-tier structure combining a national regulatory body and local regulatory functions, to be carried out by local regulators, thus recognizing both the primary role of local governments in the regulation of water services and the need for an overarching national regulatory framework to promote a consistent approach to transparent regulation throughout the country.

[39] The World Bank has supported the Government in assessing 13 PDAMs under the proposed Urban Water and Sanitation Improvement and Expansion Project, and an additional 20 PDAMs through ongoing TA. ADB has evaluated 15 PDAMs in preparing for the proposed Water Supply and Sanitation Program. Given the complex debt-restructuring arrangements, negotiations with local governments have proceeded slowly.

[40] This offering consisted of 38 toll-road projects ($9.4 billion), 12 power projects ($5.9 billion), 6 gas projects ($2.9 billion), 1 telecommunications project ($1.6 billion), 4 port projects ($ 1.5 billion), 5 airport projects ($ 0.7 billion), 24 water supply projects ($0.4 billion), and 1 railway project ($0.1 billion).

Contracts have been awarded for the three gas pipelines and one power plant, as well as for three toll roads, however the selected bidders have not arranged financing yet. Three primary reasons may explain the lack of bidders and inability to achieve more contract awards and financial closings. First, project preparation including (i) a thorough feasibility study with a risk analysis, (ii) project packaging that is appropriate for execution on a PPP basis, and (iii) a bankable draft concession agreement, has been poor. Second, the Government did not indicate any support in the bidding documents, despite major risks perceived by investors with regard to land acquisition for toll-road projects and PLN's creditworthiness for power projects. Finally, bidding was hampered by the lack of strong central coordination.

66. With the recent establishment of the PSP and risk management frameworks that address these problems (Perpres 67/2005 and MOF Regulation 38/2006), the execution of PPP projects is expected to accelerate. Demonstrating, through successful bidding and financial closing for well-prepared model PPP projects, that the investment climate in Indonesia has sufficiently improved to execute such major transactions in line with international best practice is important. In particular, the execution of such transactions must not unduly favor SOEs or other connected entities. As part of SP1, the Government has identified ten candidates for model PPP projects with combined estimated investment requirements of about $4.5 billion (Table 3). These projects will go through all the necessary preparatory steps and transparent bidding processes stipulated in the PSP and risk management frameworks.

67. Under SP2 and SP3, the process of project identification, screening, preparation, and bidding will be continuous. The bidding process is expected to be completed for the already selected model PPP projects, with the concession agreements signed and construction started. In addition, the Government is expected to proceed with a significant number of additional PPP projects.

Table 3: Candidate Model Public-Private Partnership Projects

Project	Key Features	Investment ($ million)
Central Java Coal-Fired Power Plant	2X600 MW	1,200
Pasuruan Combined Cycle Plant	1X500 MW	275
Medan–Kuala Namu–Tebing Tinggi Toll-Road Project	60 km	142
Solo–Kertosono Toll-Road Project	165 km	928
Margagiri–Ketapang Ferry Terminal	1.2 million passengers	97
Teluk Lamong Seaport	350m berth container terminal	275
Three Bulk Water Supply Projects (Bandung, Dumai and Tanggerang)	Bulk water distribution; and water pipeline	107
National Telecommunications Backbone Project	30,000 km of fiber optic network	1,500
Total		**4,524**

km = kilometer; MW = Megawatt.
Source: KKPPI.

68. **Summary of Policy Actions**. Appendix 4 presents a simplified summary of the key actions taken under the IRSDP.

3. Financing Plan

69. The IRSDP adopts a program cluster approach with three back-to-back subprograms, each covering about 21 months and supported by a single-tranche program loan. Thus, subject to approval of SP1 by the Board in October 2006, SP2 could be brought for the Board's consideration in June 2008, and SP3 in March 2010. Based on the reform agenda that has

evolved thus far, SP1 and SP2 have heavier reform content. The final agenda for SP3 will be fully developed during 2007–2009, by rebalancing outputs between SP2 and SP3 and taking into account the emerging circumstances. In addition, investment loans or other support may be added under the IRSDP to meet emerging needs. The PDF that is processed with SP1 is an example. The Government strongly supports the program cluster approach, as it provides much greater flexibility and facilitates medium-term planning. Since the approval of each subprogram is effectively embedded into the loan review process of the outcomes under the previous phase, the processing and financial implications do not differ greatly between a program cluster approach and the traditional multitranche program loan modality. However, the inherent flexibility of the former will reduce the transaction costs both for the Borrower and ADB by avoiding rigid policy conditions built into multitranche programs that frequently lead to delays because of political economy factors that are beyond the Government's control.

70. For SP1, the Government has requested a loan of $400 million from ADB's ordinary capital resources to support the reforms outlined in the policy matrix and the development policy letter (Appendix 3). The loan will have a 15-year term, including a grace period of 3 years; an interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a commitment charge of 0.75% per annum; 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 as set forth in the draft program loan agreement. The Government has given ADB (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility, and (ii) an undertaking that this choice was its own independent decision and not made in reliance or any communication or advice from ADB.

71. The loan size was determined by the strength of the policy package, its development impact, the importance of the sectors covered, and the adjustment costs arising due to the establishment of various regulatory bodies and coordination mechanisms. The Government has set aside a total of Rp.5 trillion ($520 million) for risk sharing, equity contribution to a planned infrastructure fund, and a revolving fund for land acquisition. In addition, the public sector portion of the planned PPP projects is estimated at about $2 billion in the short term. Thus, the direct needs related to measures under SP1 alone are about $2.5 billion. Viewed over the program cluster period, there are major adjustment costs imposed by restructuring of SOEs to allow for greater access and opportunities for the private sector, and the significant PSOs for pro-poor infrastructure. Essential initial steps are being taken and investments made now.

72. Subject to approvals by their respective authorities, the Government of Japan and the World Bank may cofinance SP1 on the basis of the IRSDP policy matrix and the thrust of the development policy letter. In terms of its overall financing requirements in 2006, the Government has sought $1.3 billion-$1.5 billion in program loans from ADB, Japan, and the World Bank.[41] This reflects a significantly higher fiscal deficit in 2006 (around 1.0% of GDP), due to increased development spending in the health, education, and infrastructure sectors, as well as the Yogyakarta-Central Java reconstruction assistance. These needs can be accommodated only partly through the fuel subsidy reductions in 2005. The program lending support will assist the Government in meeting the reform-related costs as well as the overall financing requirements. The macroeconomic assessment letter from the International Monetary Fund is in Appendix 6.

[41] This comprises (i) from ADB, $400 million for the IRSDP, $200 million through the Development Policy Support Program II, and the $100 million planned second tranche release under Loans 2126/2127(SF)-INO: *State Audit Reform Sector Development Program*; (ii) from the World Bank, $500 million–$600 million through its Development Policy Loan 3; and (iii) from the Government of Japan, $100 million–$300 million through cofinancing of the Development Policy Loans 2 and 3, and IRSDP.

73. In the context of the ongoing discussions about the new country strategy and program, the Government has asked that ADB provide a loan of around $300 million–$400 million for each of SP2 and SP3 based on the resource requirements.

4. Implementation Arrangements

a. Program Management

74. BAPPENAS will be the Executing Agency responsible for coordinating the implementation of the Program Cluster. The KKPPI, chaired by the coordinating minister for economic affairs, will oversee the implementation of the Program Cluster, and provide guidance and direction to the line ministries in charge of the various infrastructure sectors, which will act as the implementing agencies. Implementation of the policy actions will be coordinated with several other agencies, including SOEs and BUMDs, in charge of infrastructure provision.

b. Implementation Period

75. The implementation period for SP1 is from 1 January 2005 to 30 September 2006. All actions included in the policy matrix under SP1 have been completed during this time frame.

c. Procurement and Disbursement

76. The SP1 loan of $400 million will be released in a single tranche upon effectiveness. The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding the items specified in the negative list of ineligible items (Appendix 7) and imports financed by other bilateral and multilateral sources. In accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*, the proceeds of the program loan will be disbursed to the Borrower. No supporting import documentation will be required, if the value of Indonesia's total imports minus imports from nonmember countries, ineligible imports, and imports financed under other official development assistance is equal to or greater than the amount of the loan disbursed during the given year. The Government will certify its compliance with this formula with its withdrawal request. Otherwise, import documentation under existing procedures will be required. All goods and services produced and originating in ADB member countries will be procured with due consideration to economy and efficiency, in accordance with the Government's standard public procedures, and normal private sector commercial practices acceptable to ADB. Goods commonly traded on the international commodity market will be procured in accordance with procedures appropriate to the trade and acceptable to ADB.

d. Anticorruption

77. ADB's anticorruption policy[42] was explained to and discussed with the Government; and all relevant ADB guidelines, including the *Procurement Guidelines* (2006), *Guidelines on the Use of Consultants*, and the Loan Regulations, were specifically brought to the notice of the Government. The Government has considerably strengthened its anticorruption efforts since late 2004. Procurement reforms have been under way for some time, resulting in competitive and relatively transparent selection of bidders by the public sector. The PSP regulatory framework, adopted as part of the IRSDP, sets out clear guidelines for the selection of private sector sponsors. The KKPPI is tasked with ensuring that the bidding processes are fair and transparent. Furthermore, the President of Indonesia has considerably enhanced the profile and

[42] ADB. 2006. *Anticorruption.* Manila.

visibility of the Anti-Corruption Commission and other law enforcement agencies to deal effectively with corruption. These steps are already having an impact.

e. Accounting, Auditing, and Reporting

78. ADB retains the right to audit the use of loan proceeds and to verify the accuracy of the Government's certification for the withdrawal application. Prior to the withdrawal, the Government will open a deposit account at Bank Indonesia to receive the loan proceeds. The account will be managed, operated, and liquidated on terms satisfactory to ADB.

f. Performance Monitoring, Evaluation and Program Review

79. As the IRSDP covers nine sectors, close to 20 line ministries and agencies, and scores of SOEs and BUMDs, technical coordination and progress monitoring will be critical. The KKPPI is mandated to coordinate, leverage, and monitor reform progress within the broader context of the Infrastructure Policy Package. The line ministries, as implementing agencies, will report on progress to BAPPENAS through periodic meetings. With ADB TA support, the BAPPENAS part of the KKPPI Secretariat will strengthen the line ministry reporting system and provide technical coordination to resolve problems and facilitate implementation of pending or delayed actions. In line with CMEA Regulation 1/2006, the CMEA part of the KKPPI Secretariat will host regular stakeholder consultative meetings to solicit feedback on emerging regulations and project implementation from the private sector and development partner community. The KKPPI Secretariat's monitoring outcomes will be reported to the principal development partners and other stakeholders. In addition, joint quarterly reviews of the overall Program Cluster performance will be undertaken by BAPPENAS and ADB, in coordination with the other development partners.

80. BAPPENAS and ADB will jointly assess the impact and evaluate the benefits of SP1 within 12 months after it is completed. Findings from the consultations and reviews will be utilized in ensuring continuity and sustained progress of reforms under SP2 and SP3. As the IRSDP provides an overall umbrella framework for medium-term reforms, ADB will also solicit feedback from a wide range of stakeholders and disseminate IRSDP implementation progress, with the aim of promoting PSP in infrastructure provision. BAPPENAS will actively assist and support ongoing Program Cluster monitoring and evaluation including facilitating consultations with central and provincial agencies, infrastructure sector participants, civil society, and other key stakeholders as appropriate.

D. The Project Loan

1. Impact and Outcome

81. The project loan will help accelerate PSP in Indonesia's infrastructure sectors by supporting establishment of the PDF. The PDF will alleviate one of the most critical constraints impeding infrastructure development, namely, the lack of adequate project preparation. The PDF will help the Government (i) prepare feasibility studies for national and decentralized PPP projects; (ii) adopt open and transparent bidding processes; and (iii) execute project transactions (Appendix 8).

2. Components and Outputs

82. The Project has three components:

(i) PPP project preparation and transaction execution to establish

(a) a national component of the PDF to fund the preparation and bidding of large-scale projects, mostly in power, toll-road, and transport sectors; and

(b) a regional component of the PDF to fund the preparation and bidding of smaller-scale decentralized regional infrastructure projects;

(ii) technical advisory services to the PDF and capacity building for PPP project promotion and execution; and

(iii) procurement and administrative services to the PDF.

83. **The National Component of the PDF**. This component will help accelerate large-scale PPP project transactions. In line with Perpres 67/2005, it will finance project preparation and transaction execution, leading to the conclusion of an appropriate contractual arrangement for the project (i.e., PPP procurement). Subsequent project implementation will not be financed from the national component of the PDF. Its scope will cover large national projects, with a specific focus on preparing about 10 projects, concentrating mostly in power, toll-roads and transport sectors. Given the relatively poor access to infrastructure services, particularly by the poor, the national component of the PDF will help the Government's poverty reduction efforts by accelerating the necessary investments and encouraging PSP, which in turn will have longer term multiplier effects on poverty reduction. In addition, the national component of the PDF will alleviate acute capacity constraints within line ministries and contracting agencies in preparing projects and selecting private sector partners.

84. **The Regional Component of the PDF**. This component will support local governments in preparing at least 40 decentralized regional infrastructure PPP projects that would increase PSP. The facility's impact will be improved regional living conditions and faster economic growth through local infrastructure development. Outcomes include (i) increased PSP in regional infrastructure projects by enabling local governments to prepare bankable PPP projects, and (ii) dissemination and encouragement of best practice in structuring and executing PPP transactions. The resulting projects will be ready for financing and implementation. They will generate business and employment opportunities for a wide range of private sector participants across Indonesia.

85. **Technical Advisory Services**. This component will provide technical advisory service support to a project management unit (PMU) to be established in BAPPENAS to administer the PDF. Support for the PMU includes (i) refinement of selection criteria for providing PDF funding; (ii) assessment of requests for such funding; (iii) technical evaluation of proposals from consultants to be recruited for PPP project preparation and transaction execution; (iv) linking PPP venture proponents with financial institutions capable of funding the proposed projects; (v) advisory support to the KKPPI on cross-cutting policy or regulatory measures in the areas of anticorruption, transparency, and dispute resolution that would elicit greater PSP; and (vi) overall PPP project promotion.

2. Important Features

86. The KKPPI, as coordinator of the overall infrastructure development process, will provide oversight of the PDF through BAPPENAS. The intrasectoral prioritization of projects and submission of requests for PDF funding will be done by the concerned line ministries or contracting agencies at the national level, and local governments and related agencies at the decentralized level. The PMU will adopt clear and transparent criteria to screen requests and make recommendations for approval (Appendix 8).

3. Financing Plan

87. The total cost of the Project is estimated at $38.8 million (Table 4). The Government has requested a loan of $26.5 million equivalent from ADB's Special Funds resources. The Government of the Netherlands has advised that its formal commitment to provide $7.6 million in grant cofinancing may be expected immediately after ADB Board consideration. To expedite project implementation, Board approval to administer this proposed grant is sought. The Government of Indonesia will allocate staff and other resources for the equivalent of $4.7 million. Table 5 presents the financing plan.

88. The provision of funding from the Asian Development Fund is justified by (i) Indonesia's low infrastructure service coverage ratios compared to other countries in the region, resulting particularly in the poor not having access to basic infrastructure services; (ii) the need to support ongoing efforts to systematically rebuild national and local government capacity eroded after the Asian financial crisis; and (iii) Indonesia's relatively high debt-to-GDP ratio of 45%, and the Government's preference for borrowing on concessional terms for capacity building.

Table 4: Cost Estimates
($ million)

Component and Description	Amount	%
A. PPP Project Preparation and Transaction Execution	21.9	56.4
a. National PPP Projects	10.0	25.8
b. Decentralized Regional PPP Projects	11.9	30.7
B. Technical Advisory Services and Capacity Building	12.0	30.9
C. Procurement and Administrative Services	3.0	7.7
Unallocated	1.1	2.8
Interest and Fees	0.8	2.1
Total	**38.8**	**100.0**

PPP = Public-private partnership
Source: Asian Development Bank estimates.

Table 5: Financing Plan
($ million)

Components and Financing Source	Total	%
A. PPP Project Development Facilities		
ADB Loan (Special Funds resources)	16.5	42.5
Government of the Netherlands Grant[a]	3.7	9.6
Government of Indonesia Contribution	2.2	5.7
Subtotal (A)	22.4	57.8
B. PPP Technical Advisory, Capacity Building, Procurement, and Administrative Services		
ADB Loan (Special Funds resources)[b]	10.0	25.8
Government of the Netherlands Grant[a]	3.8	9.9
Government of Indonesia Contribution	2.5	6.5
Subtotal (B)	16.4	42.2
Total	**38.8**	**100**

ADB = Asian Development Bank; PPP = public-private partnership.
[a] The actual contribution of the Government of the Netherlands is $7.56 million.
[b] Includes $1.1 million in unallocated funds.
Source: Asian Development Bank estimates.

4. Implementation Arrangements

89. **Project Management.** BAPPENAS will be the Executing Agency. The head of the Directorate for Public-Private Partnerships in BAPPENAS will oversee the PMU and the PDF. The PMU will coordinate all three project components. PMU staff will be supported by the international and national consultants to be recruited under the technical advisory services and capacity building, and procurement and administrative services components. To ensure full adherence to the PPP legal and regulatory framework, the PMU will work closely with the central PPP unit to be established under the Directorate for Public-Private Partnerships. A Project Steering Committee as outlined in para. 20 of Appendix 8 will be established to serve as high-level decision-making and guiding forum for the PDF. The approval authority for funding requests will be different for the national and regional components of the PDF (Appendix 8, Figure 3).

90. **Implementation Period.** Project implementation is expected to start in the first quarter of 2007. The first component is expected to be committed within 4 years. Thereafter, the PDF may operate as a revolving facility, using the reflow of funds from the first batch of projects if adequate cost-recovery arrangements result from the study conducted under the second component. The capacity-building and advisory services under the second component will be implemented over 5 years. The procurement and administrative services under the third component will also be implemented over 5 years.

91. **Procurement Arrangements**: The PMU will coordinate all procurement arrangements. About 552 person-months of international consulting inputs and 3,401 person-months of national consulting services are expected to be needed to support PDF implementation. The services required under the second and third component will be procured by the PMU soon after loan effectiveness. The consulting packages under the first component will be procured on a needs basis, depending on the readiness of the concerned PPP projects. The procurement of goods such as computer equipment and office supplies, predominantly under the second and third component, will be through shopping or national competitive bidding as appropriate.

92. **Safeguard Considerations.** The PDF will not finance any investments in project implementation, as they will support only the preparation of feasibility studies and PPP procurement up to the signing of the concession agreement (or other contractual arrangements). Requests for any subsequent ADB financing for project investments will be dealt with separately, and will be subject to all of ADB's requirements, particularly with regard to environmental and social safeguards. As ADB financing is not assumed at the project preparation stage, the PDF will not be able to enforce ADB's detailed safeguard policies. However, the principles of these policies will be applied. Environmental and social impact assessment, including issues of involuntary resettlement and indigenous peoples, will be integral components in the preparation of PPP projects to be supported by the PDF. An environmental assessment and review procedure acceptable to ADB will be developed before financing any feasibility studies.

IV. Technical Assistance

93. In December 2005 (footnote 15) ADB approved TA to support the BAPPENAS part of the KKPPI Secretariat in (i) enhancing its technical capacity, (ii) developing an overall PSO framework, (iii) developing a harmonized regulatory framework for the various infrastructure sectors, and (iv) screening and preparing projects. Subsequently, the Government has asked ADB for TA to implement the risk management framework adopted by MOF as part of the IRSDP, and design institutional arrangements for the various infrastructure financing

mechanisms currently under consideration that ensure sound fiduciary governance in the provision of Government support for PPP projects.

94. The proposed TA for Enhancing PSP in Infrastructure Provision will focus on

(i) effective implementation of the risk-management framework, leading to greater PSP;
(ii) capacity building for establishing and managing the various infrastructure funds;
(iii) effective communication and social marketing of the reform agenda to a wide range of stakeholders; and
(iv) start up activities and documentation needed to support preliminary technical preparations prior to the consideration of projects by the PDF.

95. The total cost of the TA is estimated at $2,500,000. ADB will finance $2,000,000 from its TA funding program, and the Government will provide counterpart support in the equivalent of $500,000. Appendix 9 presents details on the TA.

V. PROGRAM BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Expected Impacts

96. The key benefits expected from the IRSDP are

(i) sustained progress in meeting the Government's medium-term economic growth objectives, as articulated in the RPJM for 2006–2009;
(ii) improvements in the investment climate, to be demonstrated by sound policy, legal, and institutional frameworks in the infrastructure sectors;
(iii) greater potential for PSP, and a more systematic approach for implementing PPP transactions;
(iv) preparation and implementation of quality infrastructure projects in a transparent and expedient manner, resulting in (a) improved availability and quality of infrastructure services; (b) a boost to Indonesia's competitiveness versus its regional neighbors; and (c) lower poverty incidence, through direct as well as indirect transmission channels;
(v) sustained engagement by ADB in the policy dialogue with the Government on the direction and content of, and strategies for, its economic, structural, and institutional reform agenda in the broader area of investment climate; the IRSDP will provide for policy continuity and consistency in areas where ADB has been actively involved; and
(vi) aid harmonization and parallel financing by the key development partners (ADB, Government of Japan, and World Bank) around a common policy framework and dialogue, and the positive externalities resulting from such a joint endorsement of the Government's reform agenda.

97. **Institutional.** The IRSDP will strengthen the key institutions dealing with infrastructure development in Indonesia. At the national level, the KKPPI, its secretariat and the Risk Management Unit in MOF are expected to evolve into strong institutions coordinating central support for infrastructure development through greater PSP. Within each infrastructure sector, the regulatory bodies will be strengthened over the medium term by making them independent, clarifying their mandate, and providing adequate resources for their operations. The role of SOEs will be redefined during IRSDP implementation. This will enhance their competitiveness to effectively work in an environment with much greater PSP. Overall, the capacity to prepare and execute bankable projects will be considerably enhanced. Supported by the planned long-

term infrastructure financing mechanisms, the country's financial institutions will be strengthened. The roles and responsibilities of local governments as well as BUMDs will be clarified.

98. **Social.** The IRSDP's main contribution is to improve the investment climate, and thereby contribute directly to poverty reduction, through greater access to markets, and economic and employment opportunities, among others. The adjustments in oil prices have already reduced wasteful spending considerably. The Government has utilized the additional fiscal space for more pro-poor spending. The Government will review tariff policies in all sectors and adopt tariff regimes that are in line with cost-recovery principles. At the same time, the impact of tariff increases on the poor will be mitigated through appropriate measures, and the PSO framework will be strengthened to effectively deliver essential infrastructure services. The adoption of transparent, market-based and competitive pricing will promote PSP, which in turn will lead to greater tax and non-tax revenues, and additional employment opportunities. The lessons learned from the post-fuel-subsidy program will be incorporated by the Government in designing appropriate PSO mechanisms. The Government is aware of the possible negative impact of expedient approaches to land acquisition. The recently adopted Perpres 36/2005 as amended by Perpres 65/2006 (paras.23 and 46) attempts to bring the Government's legal framework on land acquisition and involuntary resettlement closer to ADB's policies. If the ongoing dialogue aimed at strengthening the draft implementing regulations for Perpres 36/2005 and 65/2005 is successful, the Government's legal framework will be more aligned with ADB's requirements. The Government is also considering alternative approaches to provide speedy compensation and enhance administrative accountability through open and transparent dispute resolution mechanisms. Overall, the IRSDP is likely to lead to significant social benefits. Appendix 10 presents a summary poverty reduction and social impact analysis.

99. **Economic.** The nature of the IRSDP—a policy reform program—does not lend itself to a quantitative financial and economic analysis. Nevertheless, major general economic benefits will accrue to the entire Indonesian population through the IRSDP through the expanded scope and improved quality of infrastructure services. The rigorous project preparation, screening, bidding, and contracting processes will enhance the direct and indirect economic impacts of project transactions. Through its secretariat, the KKPPI will review the financial and economic analyses for all proposed PPP projects. The IRSDP will provide support to the KKPPI Secretariat in this regard, and ensure that sound assessments are carried out and the economic benefits are highlighted. Board documents for SP2 and SP3 will present updates on such assessments.

100. **Resettlement, Indigenous People, and Environment.** Perpres 36/2005 and Perpres 65/2006 recognize traditional communal land ownership (*Hak Ulayat*) and usufruct rights.[43] In line with the regulatory provisions, the rights of indigenous peoples will be upheld in the case of any land acquisition involving them. These provisions are in conformity with requirements outlined in ADB's policy on indigenous peoples.[44] ADB is preparing an advisory TA to strengthen the Government's capacity for social assessment and resettlement planning, implementation, and monitoring; and if necessary, to assist in strengthening the legal framework if the implementing regulations for Perpres 36/2005 and Perpres 65/2006 are found to be inadequate. Based on a desk review, the IRSDP measures are unlikely to have any adverse environmental impacts. Further, while the IRSDP facilitates the preparation and bidding of several model PPP projects, it will not provide any investment support to such projects. Nonetheless, the Government, through the KKPPI, will ensure that all social and environmental safeguards are complied with in line with the prevailing laws and regulations. Any projects to

[43] Subject to the caveat in para. 98 that appropriate implementing regulations would ensure a complete alignment between what is outlined in these perpreses and ADB policies.
[44] ADB. 1998. *The Bank's Policy on Indigenous Peoples.* Manila.

receive ADB financing must comply with all of ADB's social and environmental safeguards requirements.

B. Risks and Mitigating Measures

101. **Coordination Problems and Conflict of Interest.** Progress of infrastructure reforms has been impeded by poor coordination, and competing and conflicting interests of various stakeholders. In particular, political economy considerations and the lack of coordination and of a coherent vision to guide infrastructure development prevented sector liberalization and restructuring of key institutions in the past. Over 2005–2006, the Government, at the highest levels, has repeatedly reaffirmed its commitment to pursue the medium-term reforms to promote PSP. While full and effective coordination and reforms in certain sectors may take time to evolve and will need significant consensus building, the essential steps taken thus far will have a demonstrational effect in supporting infrastructure development in a coordinated manner.

102. **Poor Governance and Corruption**. With the high stakes involved in large infrastructure projects in several sectors, the IRSDP may face significant impediments in the form of weak governance, collusion, and corruption. In particular, despite the commendable rigid stance taken by MOF, risks of misallocation of scarce public resources could still be encountered, leading to public support for directly negotiated projects or projects that do not meet all relevant criteria for such support during the transition period. Problems of a similar nature have not been uncommon in the past in Indonesia. However, the Government has put in place a sound legal framework and a good mechanism of checks and balances. Equally important is the much greater degree of transparency and public debate even on such sensitive issues, which in turn offers a natural firewall around the use of budget resources and ensures compliance with due processes. Further, the Government has considerably strengthened its anticorruption efforts over the last year.

103. **Social Tensions.** Tariff reforms are sensitive in any environment, and Indonesia is no exception. As the country gradually moves away from the current system of administered prices for infrastructure services, social tensions will be inevitable. However, the savings from the reduction in inefficient subsidies will enable the Government to reorient its public expenditures toward poverty reduction, employment generation, and rural infrastructure development.

104. **Adverse Economic Developments.** Domestic macroeconomic volatility or the lack of sustained momentum on policy reforms, or adverse regional events that have a contagion effect on the Indonesian economy, would impede PSP. Over the last 3–4 years, the Indonesian economy has been quite resilient to domestic and external shocks. The Government recognizes and has addressed investors' concerns about policy reforms.

105. **Sectarian and Regional Conflicts, and Security Concerns.** The Government and law enforcement authorities have taken a range of effective measures to resolve such conflicts, which could slow private investments, and to rebuild public and investor confidence.

VI. ASSURANCES

106. In addition to the standards assurances, the Government has given the following assurances, which are incorporated in the legal documents:

(i) Counterpart funds generated from the proceeds of the program loan will be used to finance the development needs as outlined under the IRSDP implementation arrangements.

(ii) The policies and actions taken prior to the date of the IRSDP loan agreement, as described in the letter of development policy (including the policy matrix), will continue to be in effect for the duration of the IRSDP and subsequently.

(iii) The Government shall cause the line ministries, contracting agencies, and regional governments to ensure that the projects financed by the PDF will be designed and implemented in strict conformity with the applicable national laws, regulations, and policies; competitive and transparent processes; and all relevant environmental and social safeguard standards; and that the environmental and social assessments are carried out and appropriate mitigation measures, including monitoring, are prepared and implemented.

(iv) The studies and technical designs prepared for the projects and other consulting services provided will broadly comply with all relevant ADB requirements, policies, and guidelines.

(v) The Government will ensure that all necessary counterpart funds for project implementation are provided fully and in a timely manner.

VII. RECOMMENDATION

107. I am satisfied that the proposed loans would comply with the Articles of Agreement of ADB and recommend that the Board approve

(i) the program cluster for the Infrastructure Reform Sector Development Program to the Republic of Indonesia;

(ii) the loan of $400,000,000 to the Republic of Indonesia for subprogram 1 of the Infrastructure Reform Sector Development Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's LIBOR-based lending facility; a term 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 Program Loan Agreement presented to the Board;

(iii) the loan in various currencies equivalent to Special Drawing Rights 18,025,000 to the Republic of Indonesia for the Infrastructure Project Development Facility, from ADB's Special Funds resources, with interest charge at the rate of 1.0% per annum during the grace period and 1.5% thereafter, a term of 32 years including a grace period of 8 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Project Loan Agreement presented to the Board;

(iv) the provision of technical assistance not exceeding the equivalent of $2,000,000 on a grant basis to the Government of the Republic of Indonesia for Enhancing Private Sector Participation in Infrastructure Provision; and

(v) the administration by ADB of a grant not exceeding the equivalent of $7,560,000 in accordance with the proposal set out in paragraph 87 of this Report to the Republic of Indonesia for the Infrastructure Project Development Facility to be provided by the Government of the Netherlands.

Haruhiko Kuroda
President

27 October 2006

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators[a]	Data Sources/ Reporting Mechanisms	Assumptions and Risks
Impact Improved investment climate and achievement of the Government's medium-term macroeconomic goals, in particular average annual gross domestic product (GDP) growth of 6%–7% during 2005–2009, through enhanced infrastructure provision and access	Infrastructure investments increased from about 2% of GDP in 2005 to about 6% of GDP by 2011 By 2011, annual real GDP growth more than 7%	Central Bureau of Statistics data Data from the National Committee for the Acceleration of Infrastructure Development (KKPPI)	**Assumption** • Macroeconomic and political stability **Risks** • Lack of effective coordination between the concerned line ministries, state-owned enterprises (SOEs), and local governments • Public opposition to tariff and other sector reforms • Global competition and external shocks undermine capital inflows
Outcome Accelerated infrastructure development through large-scale private sector participation (PSP) and mobilization of additional public sector resources	Upward trend in key indicators on investments and project transactions (as specified under Outputs)	KKPPI and Investment Coordination Board reports	**Assumption** • Overall macroeconomic stability **Risk** • Legal and regulatory uncertainty in key infrastructure sectors
Outputs **Enhanced Cross-Sector Policy, Institutional and Legal Framework**: • Improved policy and legal framework for PSP • Well-functioning KKPPI • Sound risk management framework • Sound land acquisition mechanism, with adequate administrative accountability and social safeguards • Well-structured public and private sector long-term financing modalities	• The relevant Government, presidential and ministerial regulations on PSP fully operationalized • PPP project transactions proposed by line ministries and contracting agencies expeditiously reviewed; and recommendations on government support, if any, made by KKPPI • Government support approved by the Ministry of Finance for the first batch of PPP projects by the end of 2006 • Risk management unit fully	KKPPI reports Budget approval documents Asian Development Bank (ADB) review missions Data on financial markets Periodic monitoring meetings held by the KKPPI with the public and private sector	**Assumptions** • Government stays fully on course with key policy reform measures, and is able to coordinate effectively • Government provides adequate resources for risk management, and liaises with Parliament and other stakeholders to explain its decisions • Sound contingent liability management system in place **Risks** • Continuing nationalistic sentiments that may impede PSP by

Design Summary	Performance Targets/Indicators[a]	Data Sources/ Reporting Mechanisms	Assumptions and Risks
• Streamlined decentralization legal framework, delineating functional responsibilities between different levels of governments **Strengthened Sector Policy, Institutional, and Legal Framework** • Well-structured laws and regulations that promote competition • Independent regulatory structures that create equal access and opportunities (level playing field) for all participants • Tariff structures that are based on full cost-recovery principles • Legal and institutional framework for public service obligations (PSOs) that meets the needs of the poor **Well-Structured Infrastructure Public-Private Partnership (PPP) Projects Designed, Contracted, and Executed** • Sound model transactions designed in transportation, energy, and water supply and sanitation sectors	operationalized by the end of 2006 • At least Rp2 trillion in contingent liabilities allocated for government support for PPP projects in the 2007–2009 budgets • Land acquisition for infrastructure investments done in line with the new regulatory requirements • All sector master plans and blueprints revised and updated by the end of 2007 • PPP project pipelines reviewed and updated by line ministries and contracting agencies • At least 18 PPP projects short-listed, and 10 candidate projects selected to be pursued as model PPP projects • An additional 25–30 PPP projects identified, and their preparation and bidding started by 2010 • The project development facility (PDF) established by the end of 2006 • At least 10 large national projects and at least 40 decentralized regional projects prepared and put up for bidding under the PDF • The Government's social and environmental safeguards met by the PPP projects	stakeholders Local government reports Requests for proposals for projects Periodic advertisements and other reports as part of the bidding process KKPPI decisions after evaluation of project transactions MOF decisions on risk sharing in selected transactions Final contract awards Reports on financial closings	foreign investors • Resistance to tariff reviews and changes to the administered price system • Inappropriate risk sharing leading to fiscal losses • Resistance to the new land acquisition legal framework • Differences in views and interpretations of the Constitutional Court on key infrastructure laws and regulations

Design Summary	Performance Targets/Indicators[a]	Data Sources/ Reporting Mechanisms	Assumptions and Risks
Key Activities During 2005–2010 • Design a legal and institutional framework for PSP that ensures transparent and competitive selection of project sponsors. • Undertake measures to enhance coordination among all government institutions through the KKPPI. • Establish a risk management framework that ensures adequate risk mitigation and sharing for projects requiring government support. • Establish financing mechanisms that support public and private sector investments in infrastructure development. • Establish a land acquisition framework with adequate social safeguards. • Adopt an adequate legal framework that delineates functional responsibilities of national and local governments, and state-owned enterprises (SOEs) in infrastructure provision. • Adopt a PSO policy framework that ensures uniformity across all infrastructure sectors and provides sustained support to the poor. • Adopt sector master plans or blue prints in land transportation, railways, sea transportation, air transportation, power, oil and gas, telecommunications, and water supply and sanitation sectors. • Formulate and implement sector safety frameworks. • Revise the legal framework in all the above sectors to reflect decentralization and to eliminate SOE monopolies by separating the contracting, regulatory, and operating functions. • Adopt appropriate tariff policies in all the above sectors in line with the cost-recovery principles outlined in Presidential Regulation 67/2005. • Design and adopt regulatory arrangements in all the above sectors (as appropriate, based on sector-specific needs, constraints, and assessments) that ensure level-playing field for all operators. • Assess, design/revise, and adopt a PSO policy framework in all the above sectors that takes into account the needs of the poor. • Adequately prepare sound PPP projects in the various infrastructure sectors, select private sector partners through a transparent competitive bidding process, and proceed with project implementation.			**Inputs** • ADB program cluster of three subprograms, each covering 21 months • Single-tranche loan of $400 million for subprogram 1 • Investment loan of $26.5 million for the PDF, with a $7.6 million grant from the Government of the Netherlands • Two single-tranche loans of $300 million–$400 million for each of subprograms 2 and 3. • Cofinancing support from the World Bank and Government of Japan • Periodic review of progress under each subprogram • Reports from the monitoring group for the Infrastructure Policy Package • Technical assistance reports (TA 4728-INO: Support for Infrastructure Development; and the proposed TA on Enhancing PSP in Infrastructure Development) • Reports of the ongoing IBRD Loan 4696-IND: Private Provision of Infrastructure Technical Assistance • TA from Japan

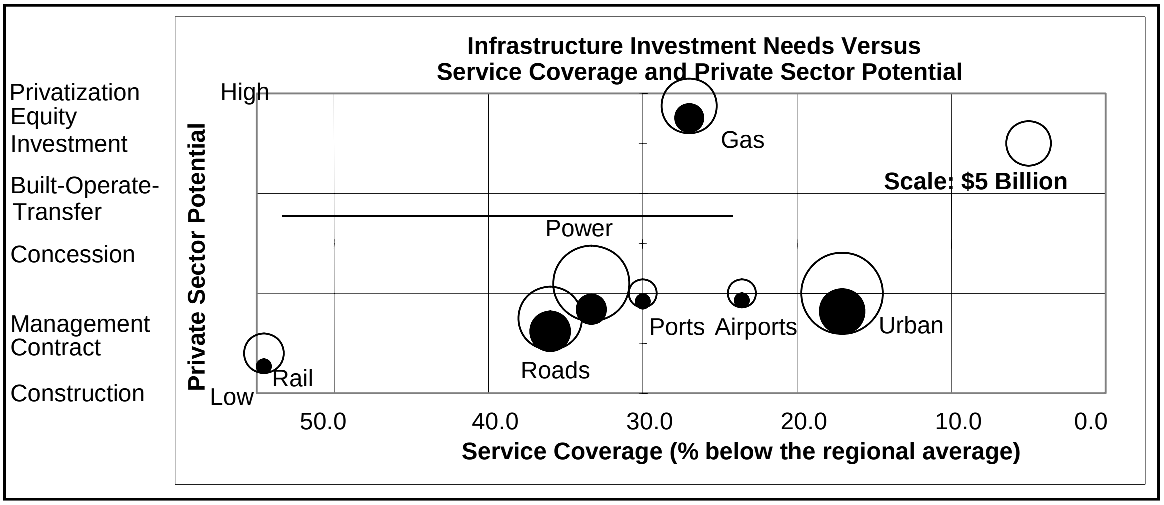
[a] Ideally, the output- and outcome-related performance targets/indicators should be expressed in terms of new infrastructure facilities constructed and the resulting increases in the access to infrastructure services. The sector master plans and blueprints do include such targets but their achievement, particularly in the medium term, is doubtful because of the continued lack of public and private investments. The targets in this design and monitoring framework therefore focus on measures to increase investments, with the understanding that the master plans and blueprints will be revised and updated under subprogram 2 to provide more realistic access and other physical targets, together with institutional and financing strategies for achieving these.

INFRASTRUCTURE SECTORS: ISSUES AND CONSTRAINTS

A. Investment Requirements

1. This appendix discusses specific issues and constraints faced in the various infrastructure sectors in Indonesia, with a summary provided in Table A2. Figure A2 illustrates the magnitude of the investment needs by sector,[1] with the outer circle indicating total requirements and the inner circle those that can be met by the public sector. The circles are positioned against each sector's potential for private sector participation (PSP) on the vertical axis[2] and the gap between each sector's service coverage and the regional average on the horizontal axis.[3] In terms of unmet investment requirements, the power sector is leading, closely followed by urban services[4] and roads. In terms of PSP potential, the gas sector is a front-runner, with the other sectors clustered below the middle line.

Figure A2: Gaps in Infrastructure Provision in Indonesia



Source: ADB staff, based on Government data.

B. Roads

2. Since roads account for the major share of domestic freight and interurban passenger land travel in Indonesia, their coverage and condition are crucial to supporting economic growth and social development. Yet the road density, at 0.19 kilometers (km) per square km or 1.7 km per 1,000 people, is among the lowest in Southeast Asia. While investments in road network upgrading and expansion were substantial in the 1980s and 1990s, sector expenditures decreased sharply after the Asian financial crisis, from a peak of around 22% of the overall public budget in the mid-1990s to about 10% in recent years. National arterial roads are in a relatively good condition, but almost half are congested, increasing costs for industry and trade, and the network comprises only about 600 km of high-grade toll roads. Provincial roads are

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[1] Asian Development Bank estimates.
[2] For example, the position of the power sector reflects the mix of a relatively high potential for PSP through build-operate-transfer projects in generation and a low PSP potential for construction in transmission and distribution.
[3] The regional average is based on data from the People's Republic of China, Indonesia, Malaysia, Philippines, Thailand, and Viet Nam. For example, with an electrification ratio of 57%, Indonesia's power sector is 33 percentage points below the regional average of 85%.
[4] Urban services include water supply and sanitation, solid waste management, and urban transport.

generally well preserved, but district and urban roads are in poor condition, with about 30% unpaved, thus restricting all-season access. In terms of spending, national arterial roads have been fairly well preserved, but the backlog of investments in network improvement and extension is growing. The regional situation is reversed, with underspending on preservation leading to greater strains than underspending in road development. Overall, of the estimated minimum annual funding requirements of Rp31 trillion ($3.3 billion), only Rp12 billion ($1.3 billion) is currently met. This underlines the need for additional domestic and foreign financial resources.

3. The current vehicle acquisition and ownership taxes, and fuel and other operational taxes would cover about 70% of the necessary road maintenance costs. However, proceeds from vehicle revenues are treated as general tax revenues of the regional governments and not designated for road preservation. The potential for financing the maintenance of road assets on a self-sustained basis is thus not utilized. Until recently, taxes imposed on road users were dwarfed by subsidies received in the form of low domestic prices of motor fuels. The gradual removal of fuel subsidies needs to continue, with a portion of the savings redirected to road development. While road preservation can be fully financed domestically through restructured road user charges, additional funds need to be mobilized for road development from the private sector and foreign borrowings. The private sector can be engaged in constructing and operating about 1,500 km of high-grade toll roads to provide a complete trans-Java link and major parts of the trans-Sumatra link, while foreign borrowings may be used in an efficient manner for improving and extending the national arterial road network, rather than for road preservation.

C. Ports and Airports

4. Ports and airports are of vital importance to regional cooperation and integration for Indonesia, an archipelago. In particular, the maritime sector comprising ports and shipping is a key mode for domestic and international trade and passenger travel.[5] Sea cargo traffic was only slightly affected by the Asian financial crisis, and is projected to grow at 6% per annum for international cargo and 4% per annum for domestic cargo. By contrast, sea passenger traffic did show some decline after the crisis that is expected to continue in the next few years before slow growth at 2% per annum is resumed.

5. Deficiencies in basic infrastructure and handling equipment include draft restrictions in some of the strategic ports that inhibit their ability to receive large vessels and fully participate in regional trade. Inadequate equipment is the main cause of generally low port productivity in terms of average berth occupancy rate, turnaround time, and containerization rate. Overall, operational performance and service provision have not met client expectations and international performance standards. In particular, performance in container terminal operations is considered unsatisfactory by port users. Port tariffs are low, allowing full cost recovery only in larger ports. With the introduction of the International Ship and Port Security Code in July 2004, all Indonesian international ports face the challenge of implementing strict security measures; receiving ports can reject docking of ships with cargo from ports that do not meet the code requirements.

6. Air transport also plays a vital role for passengers, and high-value cargo and mail by facilitating mobility, generating economic activity, and providing lifeline access to remote areas,

[5] In 2003, about 600 million tons of cargo and 10 million passengers were accommodated by 725 public and 1,478 private ports, of which 141 were classified as international ports. Twenty-five public ports designated by the Government as strategic ports providing the main gateway for passengers and cargo handle most of the container traffic.

thus helping integrate the islands across the country.[6] The civil aviation industry suffered from financial losses after the Asian financial crisis, but has bounced back and is now carrying about 60% more traffic than before the crisis. This is attributable to lower airfares as a result of competition in air transport and increasing geographic coverage of air transport services. Long-term projections indicate annual growth of 5% for domestic passenger traffic and 6% for international passenger traffic.

7. While the capacity of the airside facilities is sufficient in the main airports, terminals and aprons are sometimes inadequate. The same is true for many secondary and tertiary airports. Air traffic security also needs to be addressed. Domestic airport tariffs are kept artificially low and do not allow cost recovery for services provided to passengers and air carriers. As a result, only major airports with significant international traffic are able to break even in their operations. The initiative for proposing increases in airport tariffs lies with the airport operator. However, the operator is required to consult with users, local governments, and the Ministry of Transportation (MOT). Experience with tariff increases indicates that they are difficult to implement due to strong resistance usually expressed during the consultation process. As with ports, security of strategic airports needs to be enhanced to deal effectively with security concerns.

8. The current legal framework[7] defines the various categories of ports and airports; specifies that management of all general ports and all airports is the responsibility of the Government, which can delegate it to a state-owned enterprise (SOE); and allows PSP only through a cooperation agreement with an SOE. Based on this framework, the Government identified groups of ports and airports that are considered commercial (i.e., generate operating profits or have the potential to do so), and allocated their management and development to six SOEs: (i) 111 ports to four Indonesian port corporations (PELINDO I to IV), and (ii) 23 airports to two airport corporations (Angkasa Pura I and II). In reality these portfolios contain a mix of profitable and unprofitable assets, arranged in geographic proximity, and with positive aggregate results. The SOEs exercise monopoly rights over the ports and airports in their portfolios, managing all aspects of operation, development, and PSP. They also act as a regulator in their domain, setting tariffs for the use of port/airport infrastructure and for port/airport services in consultation with MOT. MOT, or Angkasa Pura I or II provide air traffic services, depending on the airport. This fragmented approach presents coordination and safety problems.

9. Both ports and airports have good potential for PSP, but actual PSP is low given the lack of a clear and predictable regulatory and investment environment, and the lack of a level playing field providing equal access and opportunities to all investors. In the port sector, three of the four PELINDOs have formed joint ventures with private operators. These deal structures, with the PELINDOs acting as both landlord[8] and operator, deter further PSP, as potential investors in new port terminals will not expect fair treatment from a landlord with a financial stake in an existing operator. PSP in the airport sector has been very limited, and generally taken the form of subcontracts for selected landside services. Another impediment to PSP has been uncertainty caused by regional autonomy legislation, which confers authority over public works,

[6] In 2003, aircraft movements in Indonesia's 186 airports, 24 of them international, totaled about 500,000, and air traffic passengers—departures and arrivals—about 22 million. Three airports—Soekarno-Hatta in Jakarta, Ngurah Rai in Denpasar, and Juanda in Surabaya—accounted for more than 60% of the passenger traffic.

[7] Maritime Law 21/1992, Government Regulation 69/2001, and the implementing ministerial decrees 53, 54, 55, and 56/2002 for ports; and Aviation Law 15/1992, Government Regulation 70/2001, and the implementing ministerial decrees 44,45, and 48/2002 for airports.

[8] Landlord functions in ports and airports include berth/terminal assignment, allocation of shed and warehouse space, control of all vehicles that enter and leave the ports/airports, cleaning and maintenance of infrastructure, and collection of fees.

including ports and airports, to local governments.[9] This has created a potential for conflict with the PELINDOs and Angkasa Puras.

D. Railways

10. The railway sector is very small in international terms and relative to Indonesia's size and population. It accounts for less than 10% of the country's total passenger traffic and less than 1% of its total freight traffic. Railway operations are limited to predominantly passenger services in Java and three separate networks in Sumatra that carry mainly cargo such as coal and cement. The total rail length is less than 6,000 km, mainly single-track route-km, of which about one quarter is in a nonoperating condition. Most railway assets are old and deteriorating (e.g., over two thirds of serviceable rolling stock is more than 20 years old). Despite that, the average utilization of labor and infrastructure is higher than in Malaysia, Philippines, Thailand, and Viet Nam.

11. Based on Law 13/1992 on Railways and the related implementing regulations, in particular the Government Regulation 69/1998 on Train Traffic and Transportation, the Government through MOT is responsible for sector policy and planning, regulation, and provision of basic infrastructure such as rail tracks and signaling, while the fully state-owned Indonesia Railway Corporation (KAI) is responsible for operating and maintaining the infrastructure, and providing all rail transport services. PSP is allowed through a cooperation agreement with KAI, but none has materialized so far. Since 2000, KAI has experienced declining and then stagnating demand due to low competitiveness of rail vis-à-vis road, air, and ferry services; however it reports small profits. Its real profitability is obscured by poorly implemented funding arrangements, as KAI operates within a complex web of subsidies, public service obligation arrangements, contracts with other SOEs, and caps on its economy-class passenger fares.

E. Power

12. Although the state-owned monopoly State Electricity Corporation (PLN) connected about 32 million new customers to its system between 1974 and 2004 (i.e., an average of almost 1 million per year), the electrification ratio of 57% is still low by regional standards.[10] About 90 million people lack access to electricity, and about two thirds of them live outside of Java and Bali where the cost of power supply is substantially higher. Because of the universal tariff structure prevailing in Indonesia, PLN is losing money with every residential customer it connects outside the Java-Bali grid.[11] Given the potentially huge number of such consumers, there are limits to cross-subsidization by other consumer categories. Rural electrification thus runs counter to PLN's obligation as an SOE to make a profit.[12] The implication is that the Government's ambitious target of providing electricity to 90% of the population by 2020 will be difficult to achieve with the business-as-usual approach.[13] A new rural electrification strategy needs to be developed and implemented, based on innovative decentralized models for design,

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[9] Law on Regional Autonomy 22/1999, Government Regulation 25/2000, and the revised Law on Regional Autonomy 32/2004. Government regulations 69 and 70/2001 issued to clarify the responsibilities of local governments, PELINDOs, and Angkasa Puras have not achieved the desired result.

[10] The electrification ratio may be underestimated. Other estimates indicate 67%, but even that is significantly below the regional average.

[11] Most of the off-grid regions are supplied by diesel power plants at a cost of more than Rp2,000/kilowatt-hour (kWh) and are dominated by small residential consumers charged less than Rp600/kWh.

[12] Law on State-Owned Enterprises 19/2003.

[13] The average annual growth rate in the number of PLN customers of 11.1% during the past 30 years has been impressive. However, two different patterns of growth occurred: 15.3% per year before the financial crisis, 1974–1997, and 6.4% thereafter. The sharply lower postcrisis growth is attributable to investment financing constraints and PLN's profit-making obligation.

financing, implementation, and operation. Local development utilities, either in the form of a cooperative or a partnership between a local government-owned enterprise (BUMD) and a private service provider, provide a promising approach that can be best pursued through a combination of centralized planning and coordination, and decentralized implementation.

13. PLN's current installed capacity of about 21,800 megawatts (MW) and the capacity of about 3,400 MW contracted from independent power producers are insufficient to meet peak demand outside the main grid of Java-Bali and leave an inadequate margin within it. The operation of the many captive, mostly diesel, power plants[14] has become too costly following removal of the fuel subsidy. Power demand is projected to grow at an annual rate of 6.6% through 2013.[15] To meet the forecast demand, 1,000–2,000 MW of additional generating capacity needs to be commissioned annually. PLN has a sound generation expansion program, consisting of five projects totaling 2,930 MW that will be commissioned during 2006–2007[16] and eight projects totaling 3,670 MW that are being put up for bidding in a staged manner.[17] The fact that all these projects except Cilegon and Musi are to be executed on an independent power producer basis underlines the importance of a supportive environment for private investors. In addition to these capacity additions for meeting the growing demand, the Government has embarked on a program to install within three years another 10,000 MW of coal-fired capacity through an export-credit financed crash program to displace existing high-cost oil-based power plants that are the primary cause of PLN's sharply deteriorated financial position.

14. The Electricity Law 20/2002 provides a progressive long-term vision for power sector restructuring by unbundling PLN, independent regulation, competition, and PSP. However, in December 2004, the Constitutional Court annulled this law on the grounds that its provisions for unbundling and competition violated the 1945 Constitution. The annulment was based on the interpretation of the constitutional requirement for state control of important branches of production, with the Government and SOEs acting as owners and managers. The annulment has been a serious setback for power sector reforms, with potentially far-reaching consequences for sector efficiency and financial sustainability, as well as investor confidence. A new draft electricity law is undergoing a second round of deliberations in Parliament. Some members of Parliament, Ministry of SOEs, and key stakeholders (e.g., industry and trade associations, community groups, and academicians) have recommended that PLN be split into two entities and that its monopoly rights are revoked. The generally held view is that the new law should allow for more participation from regional governments (e.g., by creating municipal utilities), private sector, and community associations.

15. Through a series of electricity tariff increases,[18] renegotiation of independent power producer contracts,[19] loan restructuring, government subsidies,[20] and efficiency improvements,

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[14] Approximately 10,000 companies maintain their own sources of power, mostly to mitigate the risks of grid supply outages. The combined installed capacity of these captive power plants is estimated at 13,000–15,000 MW, or roughly half of PLN's total capacity.

[15] Directorate General of Electricity and Energy Utilization. 2004. *National Electricity Master Plan 2004.* Jakarta. PLN's power development plan for 2006–2015 is based on demand growth of 8.5% per annum.

[16] Cilacap in Central Java (600 MW, coal); Cilegon in West Java (740 MW, natural gas, implemented by PLN with Japan Bank for International Cooperation financing); Tanjung Jati B in Central Java (1,320 MW, coal); Patuha in Central Java (60 MW, geothermal), and Musi in Sumatra (210 MW, hydropower, implemented by PLN with Asian Development Bank financing).

[17] Cirebon in West Java (600 MW, coal, bidding underway); Central Java (1,200 MW, coal); Pasuruan in East Java (500 MW, natural gas); Paiton 3 and 4 in East Java (800 MW, coal); Bali (200 MW, coal); Sibolga in North Sumatra (200 MW, coal); Amurang in North Sulawesi (50 MW, coal); and East Kalimantan (120 MW, natural gas).

[18] The average electricity tariff was increased by 29% in April 2000, 17% in July/October 2001, and through quarterly adjustments of 6% during 2002–2003. These increases brought the average tariff from about $0.025/kWh after the Asian financial crisis to $0.068/kWh in late 2003, a major accomplishment and proof of the successful socialization by the Government of this politically sensitive issue. Since then, the average tariff has decreased to $0.062/kWh due to rupiah depreciation and changes in the consumption structure.

PLN managed to overcome the disastrous effects of the Asian financial crisis and gradually reduce its net operating loss from Rp5.5 trillion in 1999 until a net operating income of Rp2.6 trillion was generated in 2004.[21] However, the fuel subsidy removal in 2005 has had a major negative impact on the financial performance of PLN, which uses diesel oil for almost 20% of its generation. Despite a massive subsidy of Rp12.5 trillion, the positive trend was reversed in 2005, as PLN was unable to pass the sharp domestic oil price increases on to its customers. In 2006 the subsidy is projected to more than double to about Rp28 trillion.

F. Oil and Gas

16. Although Indonesia is the world's sixth largest natural gas producer and supplies about a quarter of the world's liquefied natural gas from its fields in Aceh and Kalimantan, until recently the abundance of cheap oil limited the domestic use of natural gas. Moreover, lack of clarity regarding the legal and regulatory environment and poor incentives in terms of return on investment hampered expansion in current production-sharing contracts and new gas field exploration.[22] Several recent developments have set the stage for natural gas playing a much more important role. First, Indonesia has been on the verge of becoming a net oil importer over the last two years. Second, the fuel subsidy reductions in March and October 2005 have made natural gas competitive. Third, the legal and regulatory framework has been strengthened. As a result, private investors are poised to develop new large gas fields, and PLN is keen to substantially increase the share of natural gas in its generation mix. Major pipeline projects and/or liquefied natural gas terminals need to be implemented to bring natural gas to the Java market. For the former, a public-private partnership project successfully completed by the State Gas Corporation (PGN) is one possible approach.[23]

17. The Oil and Gas Law 22/2001, together with the related implementing regulations,[24] provides a basis for gas sector restructuring by ending the monopoly of the State Oil and Gas Corporation (Pertamina) both in the upstream and downstream part of the sector, and establishing separate contracting authorities for these parts (BP Migas and BPH Migas). Though similar in its philosophy to the annulled Electricity Law 20/2002 (para. 14), the Oil and Gas Law 22/2001 was upheld by the Constitutional Court in December 2005, except for provisions related to domestic market obligations, and oil and gas pricing. The Constitutional Court ruled that a minimum allocation for the domestic market should be stipulated for oil and gas producers, and that gas prices should be set administratively rather than be determined by competition.

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[19] The renegotiations were a complex and protracted exercise with a successful final outcome. Of the 27 independent power producer contracts totaling 11,300 MW, 14 contracts for 5,690 MW were continued under renegotiated terms, 6 contracts for 4,490 MW were terminated, 6 contracts for 900 MW were acquired by the Government and its SOEs, and only 1 contract for 220 MW ended in a legal dispute.

[20] The subsidies were introduced to compensate PLN for its low tariff for small consumers and amounted to Rp4.7 trillion in 2002, Rp4.1 trillion in 2003, and Rp3.5 trillion in 2004.

[21] PLN's net income after interest, taxes, and foreign exchange losses was negative throughout this period, but the loss decreased from Rp6.1 trillion in 2002 to Rp2.0 trillion in 2004.

[22] Gas contracts signed before 1971 still account for almost 60% of Indonesia's commercial reserves, and large gas fields have remained unexplored.

[23] PGN created a subsidiary company for the construction and operation of the Grissik-Duri-Batam-Singapore gas transmission pipelines with a combined length of about 1,000 kilometers and divested a stake in this company to a strategic investor through a competitive bidding process. The project was supported by an Asian Development Bank loan of $218 million, with cofinancing of $195 million provided by Japan Bank for International Cooperation.

[24] The government regulations on Implementing Agency (BP Migas), Regulatory Agency (BPH Migas), Corporatization of Pertamina, Upstream Businesses, Downstream Businesses, and Appointment of the Head of Implementing Agency, as well as the Presidential Decree on the Establishment of Regulatory Agency, issued during 2002–2004.

18. BPH Migas has undergone capacity building to fully operationalize its downstream regulatory functions. Under the current arrangements, the Ministry of Energy and Mineral Resources is responsible for policy making, regulation of upstream activities, and together with BPH Migas, regulation of downstream activities.[25] BP Migas acts as the contracting authority for upstream work and BPH Migas for downstream.

G. Telecommunications

19. Except for a few years when the impact of the Asian financial crisis was strongly felt across the country, the fixed line service has shown double-digit annual growth since 1970. The total number of fixed lines exceeds 11 million, but given Indonesia's large population, the coverage is among the lowest in the region.[26] A large disparity exists between urban and rural areas.[27] As elsewhere in the region, mobile communication has enjoyed explosive growth since 1995, reaching about 27 million mobile phone users in 2004. The density is thus more than twice as high as for fixed lines.[28] While the number of Internet users has also increased to about 8 million, Indonesia lags most countries in the region.[29]

20. Until 1999 the responsibility for the provision of telecommunications services was assigned to two SOEs. Telkom was designated as the so-called organizing body and granted exclusivity for domestic services (both local and long distance), while Indosat played this role for international services. Law 36/1999 on Telecommunications and the related implementing regulations provided the basis for major sector reforms. These are outlined in the 1999 sector blueprint that envisages a gradual transition to full competition by 2010. The Government removed the respective monopolies of Telkom and Indosat, partially privatized them,[30] eliminated their cross-holdings in other operators, and established the Indonesian Telecommunication Regulatory Body (BRTI). While competition is strong in the profitable mobile phone market,[31] Telkom continues to monopolize the fixed-line business, using its dominant position as a provider of basic infrastructure. Indosat has made little inroads in this market segment, despite having a license for domestic local and long-distance services. Telkom is also dominant in Internet services.[32]

H. Water Supply and Sanitation[33]

21. Among the various infrastructure sectors in Indonesia, water supply and sanitation are in the worst technical and financial condition. Only about 40 million people, or 18% of the population, are connected to piped water supply from regional water supply companies (PDAMs). Even in urban areas, only 33% of people receive piped water. The remaining urban population depends on individual wells, small-scale providers, or water vendors, often at high

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25 The regulatory role within the ministry is exercised by its Directorate General of Oil and Gas (DG Migas).

26 About 4 fixed lines per 100 inhabitants, compared to about 4 in the Philippines, 5 in India, 6 in Viet Nam, 11 in Thailand, 18 in Malaysia, and more than 20 in the People's Republic of China.

27 The six largest cities—Jakarta, Surabaya, Semarang, Bandung, Medan, and Denpasar—with less than 10% of the country's population account for almost 50% of all fixed lines.

28 About 9 mobile phones per 100 inhabitants, which is well above India (2) and Viet Nam (3), but distinctly below People's Republic of China (22), Philippines (27), Thailand (40), and Malaysia (45).

29 Less than 4 users per 100 inhabitants, compared to about 2 in India, 4 in the Philippines and Viet Nam, 6 in the People's Republic of China, 11 in Thailand, and 34 in Malaysia.

30 The privatization started with the listing of Telcom and Indosat on the New York stock exchange in 1995 when about 5% of shares were offered to the public. It continued with a few subsequent listings and partial divestments, with the largest transactions undertaken in the banking subsector.

31 Six companies have national licenses, among which Telkomsel is leading with a market share of about 50%.

32 Of the approximately 190 licensed Internet service providers, some 35 are active. Telkom controls over 60% of the market.

33 Data in this subsection are derived from World Bank. 2004. *Indonesia. Averting an Infrastructure Crisis: A Framework for Policy and Action.* Jakarta.

cost. In rural areas, the situation is much worse. Only about 15% of rural households get drinking water from pipe or pump sources, with PDAMs accounting for about half of it. The majority of rural households still rely on shallow groundwater extraction or rainwater collection, or use surface water from nearby rivers or springs. The poor are affected most by this unsatisfactory situation. Countrywide, less than 20% of the poor have access to safe drinking water, compared to more than 80% of the rich. The poor pay water vendors up to five times more than the rich who use piped water.

22. Wastewater disposal is almost entirely handled by local governments. Indonesia has one of the lowest rates of urban sewerage coverage in Asia. Only seven cities have some form of sewerage networks that reach just 10% of urban residents. Over 70% of urban households have on-site sanitation, mostly in the form of septic tanks that are not functioning effectively. In rural areas, less than 30% of households have toilet facilities, and only about 20% septic tanks. The lack of adequate sewerage systems, combined with inadequate solid waste management, has caused widespread contamination of surface and groundwater. These conditions explain the high incidence of waterborne diseases. Indonesia has the highest incidence of typhoid in East Asia, and diarrhea is the second largest cause of death among young children.

23. The more than 300 PDAMs are under the jurisdiction and ownership of local governments. The majority are struggling, with their financial situation deteriorating and service quality falling. About 70% of the PDAMs are heavily indebted, having on their books more than 400 outstanding loans from the Ministry of Finance that need to be restructured; almost two thirds are in arrears or default.[34] Tariffs are well below cost-recovery levels, and often do not even cover costs for operation and maintenance. The PDAMs function with little autonomy from local governments, which keep tariffs artificially low and demand dividends that reduce funds for maintenance and investments. Total annual PDAM losses are very high. Averaging about 40%, unaccounted for water is clearly excessive and loss reduction programs have been mostly unsuccessful. The large number of PDAMs is a concern, because many are too small to be sustainable.

24. The sector suffers from low investment, a situation aggravated by the Asian financial crisis. Particularly in sanitation, investment has been almost negligible, and cost recovery considered irrelevant. Annual investments of about $600 million are estimated to meet the Millennium Development Goals for water supply and sanitation.[35] The bulk of financing will have to come from cash generated by the PDAMs and local government budgets. This calls for major improvements in the self-financing capacity of PDAMs, and in the borrowing capacity and financial management of local governments. Ensuring access of the latter to long-term finance is particularly important. The gap between the investment needs and public sources of funds, including foreign borrowing, will have to be closed by sharply increased PSP.[36]

[34] The money owed by the PDAMs to MOF totals about Rp5 trillion.

[35] The target is: Halving by 2015 the proportion of people without sustainable access to safe drinking water, and significantly improving by 2020 the lives of at least 100 million slum dwellers through improved sanitation and other measures.

[36] Except for three water supply concessions (two in Jakarta and one in Batam), PSP in the sector has been insignificant.

Table A2: Key Infrastructure Issues

Sector	Legal Framework	Regulatory Framework	Financial Sustainability	Other Issues
Oil and Gas	• Oil and Gas Law 22/2001 (amendment) • IRs	• Operationalization of BPH Migas	• Fuel subsidies • Domestic gas pricing	• Gas exploration • Gas transmission
Power	• Electricity Law 20/2002 (revision) • Energy Law (new) • IRs	• New independent regulatory body	• Electricity tariffs • Lifeline tariff • PSO policy	• Capacity shortages • Rural electrification strategy
Roads	• IRs for Road Law 38/2004	• Operationalization of BPJT	• Toll road fees • Road user charges • Road fund • PSO policy	• Road development and maintenance • Vehicle overloading • Road traffic safety
Ports	• Maritime Law 21/1992 (revision) • IRs	• New independent regulatory body	• Port tariffs • PSO policy	• Port security • Regional autonomy
Airports	• Aviation Law 15/1992 (revision) • IRs	• New independent regulatory body • Separation between airport and air traffic service operation	• Airport tariffs • PSO policy	• Airport security • Regional autonomy • Air traffic services
Railways	• Railway Law 13/1992 (revision) • IRs	• New independent regulatory body	• Railway tariffs • TAC, IMO, and PSO policy	• Competitiveness vis-à-vis other transport modes
Telecommunications	• IR on interconnection	• Operationalization of BRTI	• Telecommunications tariffs • PSO policy	• Duopoly structure • Service coverage in rural areas
Water Supply and Sanitation	• IRs for Water Resources Law 7/2004	• Operationalization of BPP SPAM	• Debt restructuring • PDAM consolidation • Water and sewerage tariffs • PSO policy	• Unaccounted for water • Service coverage
Cross-Sector Issues				
Private Sector Participation	• Government commitment to reform (IISs) • PSP framework (revision of Keppres 7/1998) • Central level coordination (KKPPI and PPP network) • Stakeholder consultations (CIIF) • Land acquisition • Project preparation and execution			

Risk Management	• Risk management policy • Institutional arrangements (Risk Management Committee/Unit)
Infrastructure Financing	• Pension funds and insurance • Infrastructure funds • Government bond market • Onlending and ongranting to local governments • Municipal and rural infrastructure finance facility

BPH Migas = Badan Pengatur Hilir Minyak dan Gas (Regulatory Body for Oil and Gas Downstream Business), BPJT = Badan Pengatur Jalan Tol (Indonesian Toll Road Authority), BPP SPAM = Badan Pendukung Pengembangan Sistem Penyediaan Air Minimum (National Water Regulatory Agency), BRTI = Badan Regulasi Telekomunikasi Indonesia (Indonesian Telecommunication Regulatory Body), CIIF = Consolidated Indonesia Infrastructure Forum, IIS = Indonesia Infrastructure Summit, IMO = installation, maintenance, and operation, IR = implementing regulation, KKPPI = Komite Kebijakan Percepatan Pembangunan Infrastruktur (Committee on Policy for the Acceleration of Infrastructure Development), PDAM = Perusahaan Daerah Air Minum (local public water utility), PPP = public-private partnership, PSO = public service obligation, PSP = private sector participation, TAC = track access charge.

Source: ADB staff.

Letter of Development Policy from the Government of Indonesia
Infrastructure Reform Sector Development Program

24 October 2006
Jakarta, Indonesia

Mr. Haruhiko Kuroda
President
Asian Development Bank
Manila, Philippines

Dear Mr. Kuroda:

I. Introduction

1. The Government of Indonesia (the Government) has now successfully completed almost two years in office. With principal focus on accelerating economic growth and reducing poverty and regional disparities, the Government has progressed on the reform agenda against a backdrop of extraordinary circumstances in 2004-2006. The devastating natural disasters in several areas such as Aceh, Nias, Yogyakarta, Central and West Java and South Sulawesi, while posing enormous challenges, have not deterred us from moving ahead on national economic priorities. In parallel, the Government has also made marked progress on the governance front, by strengthening key institutions and considerably enhancing transparency.

2. The Indonesian economy grew at 5.6% in 2005 - the best performance ever since the crisis. Growth in 2006, and to some extent in 2007, will be conditioned by the Government's bold decision in October 2005 to reduce the escalating fuel subsidies and bring domestic fuel-oil prices closer to international parity. For 2006, our growth projection of 5.7-5.9% hinges on accelerating development spending in the second half of the year. Fiscal consolidation has been our principal anchor in macroeconomic management, and it will continue to guide us in the future. However, recognizing that Indonesia lags behind in health and education attainments, and in infrastructure access, the Government is poised to scale up public spending in these areas. As a result, we aim at a higher deficit of 1.3% in 2006 while for 2007 the deficit is projected at 1.1%. A comprehensive community-driven development program is under preparation to scaleup the provision of public services and infrastructure in the regions.

3. Notwithstanding the favorable macroeconomic performance, the Government is acutely aware that the current levels of economic growth would still not be enough to create sufficient job opportunities, reduce employment and cut poverty levels. For the economy to generate 2 million new jobs every year and to create wealth to halve poverty to around 8% by 2010, Indonesia needs to grow at 7-8% every year. Investments – particularly in infrastructure – are vital to accelerate growth. Indonesia used to invest upwards of 6% of GDP on infrastructure prior

to the 1997 Asian financial crisis. Now, with investments at around 2% of GDP, poor infrastructure is already starting to constrain the pace of our economic growth and impact the quality of our basic public services. Since the crisis, the Government's ability to support infrastructure development has been limited by budgetary constraints. As a result, we confront a substantial infrastructure financing gap. Indonesia is now at a critical juncture where we need to accelerate public spending on infrastructure, as well as to attract private sector participation (PSP). PSP in infrastructure is accordingly an imperative rather than an option.

4. Enhancing PSP and formulating effective public private partnerships (PPPs) in infrastructure provision need wide-ranging sector and cross-sector reforms. We requested the development partners for support in articulating as well as implementing reforms following the January 2005 Indonesia Infrastructure Summit. Subsequently, the Government adopted a comprehensive Infrastructure Policy Package (IPP) in February 2006 which outline the key initial actions to be taken by the line ministries, state-owned enterprises and infrastructure contracting agencies in 2006. The IPP benefited from inputs from development partners, under ADB's coordination. Based on the work done over the last one-and-half years, a medium-term reform program has been put together, as outlined in the Infrastructure Reform Sector Development Program (IRSDP). The IRSDP expands the agenda in the IPP to clearly outline reforms during 2005-2010, as the complex regulatory, institutional and policy changes need time and significant consensus building.

5. This Letter of Development Policy is in support of our request that the ADB approve the overall IRSDP cluster comprising three subprograms and a $400 million loan for Subprogram 1 to disburse in fiscal year 2006. We have also requested the World Bank and the Government of Japan (GOJ) to provide co-financing support for the reforms implemented under Subprogram 1 of IRSDP. The Letter should be read in conjunction with the Policy Matrix (Attachment 1), and together they constitute this Government's medium-term reform commitment in infrastructure sectors.

II. Infrastructure Reforms – Achievements, the Road Ahead, and Our Vision and Commitment

A. The Challenge and Scope of Reforms

6. **Focus on Good Governance**: Since taking office in October 2004, the Government has focused on ensuring good governance in public administration. We have reforms underway in a wide range of areas with focus on preventing corruption, including: procurement, public financial management, internal controls and auditing, and gradual progress towards performance orientation. In parallel, we have taken significant measures to strengthen our institutions such as the Anti-Corruption Commission (KPK), the Anti-Corruption Court, and the Judicial Commission, among others. In the infrastructure sectors in particular, the Government is committed to enhancing governance along several directions which includes: policy, legal and regulatory framework; sector-level planning and implementation; and open and transparent project transactions.

7. **Sector Coverage**: Given the need to enhance the quality and quantity of infrastructure services across the board, our program – as encapsulated by the IRSDP - covers nine

infrastructure sectors, including land transportation, toll roads, railways, air transportation, sea transportation, power, oil and gas, telecommunications, and water supply and sanitation. Such a wide coverage means a plethora of complex reforms. We have used the time since the first Indonesia Infrastructure Summit in January 2005 to draft amendments to various laws and regulations, strengthen institutional structures, and put in place initial sector plans and blue prints, to pave way for accelerating infrastructure development through public investments and greater PSP. These sector plans will be updated during the course of IRSDP, as well as used a basis by KKPPI for recommending Government support to the Ministry of Finance. A new roads law was enacted in 2004, and the drafts of new laws on electricity, railways, sea transport and air transport are now being deliberated by Parliament.

8. **Access Issues**: The lack of investments and the absence of an accommodative framework over the last decade have prevented Indonesia from increasing access to infrastructure. In particular, we face serious power shortages in some regions and lack of access to adequate and clean water supply and sanitation facilities in general across the country. In the power sector, if we take “electricity for all” as the goal by 2020, we need to achieve about 1 million new connections in rural areas every year. At present, we are in the 200,000-300,000 range with regard to rural electrification. Only 18% of the country has access to safe and clean drinking water supply through piped sources. Given the archipelagic nature of the country, inter-island sea transportation is very vital, but the service coverage is inadequate. Accelerating economic growth needs greater access to roads of high quality, an area where we need to construct at least about 1,000 kilometers of new tollroad networks by 2009, not including the other national and local level highways. Our line ministries are committed to developing comprehensive sector coverage strategies - building on the masterplans and blueprints developed - particularly in the power, roads, and water supply and sanitation sectors. In particular, through the course of IRSDP, the concerned line ministries and/or agencies have undertaken to:

- Refine the Government’s electricity access strategy by considering options including the potential contributions of user payments and subsidies, the role of sub-national governments, and regionally differentiated approaches to electricity access;
- Refine water access strategy by: (i) setting targets based on credible financing arrangements; (ii) addressing the relative roles of financing through development assistance, domestic borrowing, user tariffs and government subsidy; (iii) developing criteria for access by regional water utilities (PDAMs) to government finance that provides incentives for enhanced financial performance; and (iv) developing approaches for reducing the level of PDAM debt arrears.

9. **Affordability**: The present Government has been bold in sharply reducing the fuel oil subsidies in March and October 2005. It has also adopted regulations in some sectors allowing for cost-based tariff setting policies, for instance for water supply and toll roads. Our regulatory framework (elaborated below in para.17 below) provides for full cost recovery to enable greater PSP. However, the Government will have to balance economic growth considerations vis-à-vis social balance and equity. Our subsidy policies are gradually moving towards more equity, by targeting and protecting the poor and charging progressively higher tariffs for those with greater ability and willingness to pay.

10. **Public Service Obligations (PSO)**: As we accelerate infrastructure development, equitable access to services is an important issue to address, given the geographic spread and size of the country. There are significant PSOs in some sectors. Several SOEs have mandated and clear PSOs that they are obliged to fulfill. In some sectors, subsidized services are delivered through other modalities (including contracting out to private operators). The basic issue in such cases is that services cannot be provided on a full-cost recovery basis. As part of the IRSDP, the Government is committed to adopting a uniform and consistent PSO policy across all sectors. Further, each sector ministry will also prepare a sector-specific PSO policy and begin its implementation during the course of IRSDP, to ensure that the PSO obligations are delivered. Further, it is our view that PSO provision can also be fulfilled through greater PSP, besides increasing efficiency.

B. Accelerating PSP

11. **Basics for Enhancing PSP**: While we see the need for PSP, we also acknowledge that it will not be easy to persuade private sector investors to meet it. As in other sectors, we understand that investment decisions are taken on the basis of perceptions of risk and expectations of return. And, we are aware that risk perceptions are currently deterring many prospective infrastructure investors and lenders, or otherwise causing them to seek levels of return that are socially and politically unsustainable. Thus, our ability to meet our expectations for PPPs in infrastructure provision will depend in considerable measure on our ability to address risk issues.

12. We acknowledge, at the outset, that our initial high targets for private infrastructure investment have not been met. On the other hand, we do have to stress that we have learned many important lessons as a result, and are now starting to apply these. The Government has accelerated reform of infrastructure sector policies, including by:

- Establishing more transparent and predictable regulatory regimes;
- Eliminating inappropriate State-enterprise 'exclusivities' that preclude or inhibit competition
- Enabling improved modalities for PPPs

13. **Scope for PPPs**: PPPs are not really new in Indonesia. We have opened our infrastructure activities to the private sector back in the early 1990s. But, not all past experiences dealing with PPPs were considered a success story. Our experience in the electricity sector is obviously one example of bad story. That failure of implementing PPPs has not only created a significant financial cost to the Government and State Electricity Corporation (PLN) but also has undermined our credibility. We do not want repeat those bad experiences and we intend to adopt best practices for the PPP.

14. **Need for Change Management**: Opening the doors to private infrastructure investment necessarily requires behavioral and cultural changes in the government agencies and State enterprises tasked with project preparation, tendering, negotiation, and implementation oversight. We recognize and acknowledge that we have previously underestimated the scope and complexity of the needed changes. The Government is taking the following actions in order to reduce the resistance of the public to PPPs:

- Involve stakeholders from the initial stages of PPP projects;
- Clearly show the objective of PPP projects through proper public relations; and
- Present and process and adequate number of model projects as showcases of PPPs.

15. **Foundational Regulatory Framework for PSP**: Overcoming the above problems will require strong direction and leadership, both at the political level and within the responsible institutions. We have reactivated the National Committee on Acceleration of Infrastructure Development (KKPPI) – as a mechanism for driving and facilitating decision-making. One of the early tasks assigned to KKPPI was to prepare an improved cross-sector regulation on PPPs. As outlined in the IRSDP policy matrix, the Government has taken a set of key regulatory measures in enhancing PSP. We have adopted Presidential Regulation No.67/2005, that defines the 'rules of the game' for PSP as well as cooperation between the public and private sectors in infrastructure provision which is in line with international best practice.

C. Designing PPPs Effectively – Need for Project Preparation

16. We also recognize that many of the projects offered to the private sector recently, for various reasons, have not been prepared to sufficiently high standards. In particular, feasibility studies and other documentation have not provided adequate information for prospective investors on some key risk areas. Unfortunately, time is not on our side here, and we cannot afford to restart the preparation process for all projects in our current pipeline. Rather, the Government is now pursuing a two-fold strategy under which we are:

- Striving to improve the documentation of projects that are already far advanced in preparation; and, in parallel
- Initiating the preparation of a carefully selected set of "best practice" demonstration projects, which also serve as models for the future.

17. **Project Preparation**: In view of the capacity constraints at national and local levels, the Government is now establishing a Project Development Facility (PDF) – included under the IRSDP – to ensure that adequate funding is available for the timely preparation of promising projects to the exacting standards expected by prospective investors and lenders. The PDF will help develop the Government's own capacity, while at the same time building a robust pipeline of PPP projects. BAPPENAS is in the process of establishing a PPP Central Unit to coordinate the implementation of the overall PPP framework. The PDF will be an integral part of the PPP Central Unit, and its activities will be fully coordinated with that of the Unit.

D. Accelerating PPPs – Need for Model PPP Transactions

18. Translating the good policy, legal and regulatory measures accomplished over 2004-2006 into improvements in infrastructure access calls for actual project transactions. At the first Indonesia Infrastructure Summit in January 2005, the Government announced a catalogue of 91 projects in the various sectors. We have made some progress in the interim, with about 20 projects in the power and toll road sectors in particular going through the pre-qualification or bidding stages. A few projects have been awarded in the gas, power and water supply sectors. Efforts are underway at present to achieve financial closure. Far more needs to be done.

19. As part of the IRSDP, the Government has identified several candidate Model PPP Projects, which are presented in Table 1 at the end of this letter. The Government will table detailed information memoranda on as many of these projects as possible at the November 2006 Infrastructure Conference and Exhibition. These Model PPP Projects will fully comply with Perpres No.67/2005 and MOF Decree No.38/2006. Their preparation will be supported by the PDF or other available sources. In parallel, as part of the preparatory process, the KKPPI and MOF will work together with the line ministry or contracting agency concerned in determining the type and level of Government risk-sharing support for the projects. Once this decision is taken, then the PDF or other sources will help in the bidding and transaction execution process. Our goal is that as many of the Model PPP Projects as possible would have reached the bidding stage during the course of 2007. We will also initiate preparatory work for a subsequent set of PPP projects to be pursued over 2007-2010. We need to adopt a gradual approach in executing such projects. Our line ministries also need to build consensus and, where applicable, to convince the concerned SOE to adopt the best possible approach from the country's point of view. But, we remain confident that a number of good PPP projects will be identified, prepared and implemented during the course of IRSDP.

E. Accelerating Infrastructure Development through PPPs – Need for Prudent Risk-Sharing Arrangements

20. **Risk-Sharing Framework**: The Perpres No.67/2005 framework is supplemented by the Minister of Finance Regulation No.38/2006 on Implementing Control and Management of Infrastructure Provision Risks. This regulation highlights the need for the risk management process to support the provision of infrastructure so as to enable more rapid economic growth while ensuring fiscal sustainability. Among others, it defines:

- The types of risk that the Government is willing to bear or share, namely certain types of political, project performance, and demand risks;
- The types of Government contingent support that can be considered, and the criteria to be used in deciding the form and amount of Government support;
- The procedures to be followed in evaluating and responding to requests for Government support, including making the needed budgetary provision; and
- The requirements for monitoring and reporting on the evolution of project risks.

21. **Initial Allocation of Resources for Risk Sharing**: To help implement the risk management framework effectively, a Risk Management Center (RMC) has been established in MOF. In order to help operationalize the framework, the Government has proposed that about Rp.2.5 trillion be set aside in the 2006 and 2007 budgets for risk-sharing support. Subject to needs, it is envisaged that adequate resources can be allocated in the 2007 supplementary budget, and 2008 and 2009 budgets. In the initial stages, tentatively July 2006-June 2007, the RMC will function with the help of consultants while at the same time building the capacity of MOF staff in risk assessments. The RMC will become operational with a full complement of qualified staff from mid-2007 onwards.

22. **Institutional Arrangements for Determining Risk Sharing Support**: The Government is close to finalizing a Government Regulation on Investment Funds under the Treasury Law (Law No.1/2004). This is expected to be completed and endorsed by the President before the end

of 2006. In parallel, the Ministry of Finance is working with the ADB and World Bank on establishing a Guarantee Fund by June 2007. The Rp.2.5 trillion that has been tentatively set aside from the State Budget for risk-sharing purposes will be held in the Guarantee Fund, as the Government's initial contribution. In addition, we have also requested the development partners to support the strengthening of the Guarantee Fund through their partial credit guarantee or risk management products. In order to ensure good governance, particularly to adhere to the highest principles of fairness and transparency, the Guarantee Fund shall be used only for those PPP projects that fully comply with all the provisions of Perpres No.67/2005 and MOF Decree No.38/2006.

23. **Overarching Focus on Good Governance in Determining Risk-Sharing**: At the outset, the principles that underlie our policy on risk sharing are as follows:

- Some Government support is necessary and should be given in accordance with the risk sharing framework;
- Risk must be allocated to the party that is best able to manage it; and
- The level of Government support will be gradually reduced along with improvements in investment climate.

24. With limited resources available and the past mixed history of Government support, it is critical that we adhere to strict good governance norms. One such principle is transparency, and MOF has been strictly adhering to this. For purposes of determining Government support, we have categorized projects into three types:

- **Category 1: Projects to be Directly Executed by the Government or Contracting Agencies**: Given the urgent need to expand the provision of infrastructure services, the Government plans to design and execute infrastructure projects with public sector resources (including foreign loans guaranteed by the Government). An example is the 10,000 MW crash program for electricity generation. This program will be executed by PLN. There may be other programs or projects of this nature emerging in the future, wherein our goal will be to enhance infrastructure provision.

- **Category 2: PPP Projects (Awarded through Bidding) or Other Projects (Awarded through Direct Selection) prior to Perpres No.67/2005 and MOF Decree No.38/2006**: For this category we will apply all the relevant provisions of our regulatory framework in determining Government support. If the proposed projects do not meet the requirements of Perpres No.67/2005 and MOF Decree No.38/2006, then we will apply the principles of transparency, accountability, proper risk allocation and sharing, and fiscal prudence in determining fiscal support for such projects through the general budget allocation process.

- **Category 3: PPP Projects Prepared and Awarded on the Basis of Perpres No.67/2005 and MOF Decree No.38/2006:** Our commitment is that this is the only category of projects - which also includes the Model PPP Projects (see para.20 above) pursued through IRSDP or other initiatives – that will be supported through the Guarantee Fund, subject to the needs and all the criteria being fully met in a fully

satisfactory manner. Some projects may also be supported through the general budget allocation process, if the needs so warrant.

25. **Need for Transparency**: In determining Government support, our foremost aim is to adhere strictly to the principles of good governance, anchored on transparency and fiscal prudence. At the same time, the Government needs to adopt a pragmatic approach, as this is the first time since the financial crisis that the Government is attempting to deal in a systematic manner with public support for large scale infrastructure projects. Nonetheless, from an overall resource allocation point of view, we will adhere to a key underlying principle that the Category 3 projects should not be crowded out by support for the other categories. The Government is also aware of the importance of open competitive selection processes and of the need for Cooperation Agreements to align with accepted international practices, including in particular in the area of risk allocation and sharing. With this in the background, we have been working to develop improved model agreements in sectors such as toll roads, power, ports, airports, railways, water, and gas pipelines.

F. Other Essential Reforms in Attracting and Implementing PPPs

26. **Leveling the Playing Field**: Our vision is to achieve clarity of institutional roles in the provision of key infrastructure services, including through assigning responsibilities for policy-making, contracting, operational, and regulatory functions to separate agencies. As each performs specific tasks, there should not be any conflict of interest in their roles. There already is some degree of separation between the four functions in particular in the toll roads, telecommunications, gas and water supply sectors. Over the course of the IRSDP, the Government will continue the gradual separation of the four functions to eliminate any conflicts of interest and level the playing field. Though our vision is clear, the progress will be subject to the relevant laws being adopted by Parliament, which is beyond the executive's authority.

27. **Addressing Social Safeguards:** It is not an easy challenge to balance the need to accelerate large-scale infrastructure investments, and the need to maintain acceptable minimum social safeguards. In Indonesia, like in any other country, the issue of land acquisition is a complex subject. In 2005, Presidential Regulation No.36/2005 was adopted to replace the earlier 1993 decree on land acquisition for public purpose. Subsequently, with a view to accelerating infrastructure investments, we have further amended the regulatory framework through Presidential Regulation No.65/2006. Together, we are confident that these two regulations will satisfactorily resolve most of the residual problems. In particular, we believe this regulatory framework is a significant improvement over the previous set of regulations. Once it comes into effect, land acquisition for public purposes will be more transparent and expeditious. Through the IRSDP, we also commit to reducing the gaps between the Indonesian legal framework and the policies of external financing partners.

28. **Addressing Environmental Considerations**: As Indonesia moves forward to accelerate infrastructure development after the crisis, the Government is cognizant of the need for stronger environmental protection policies and more effective implementation. We have already taken steps to improve the overall legal and regulatory framework for environmental management and are committed to enabling provision of adequate resources for AMDAL units at various levels of

the Government. In addition, we would also explore how environmental considerations can be integrated more effectively in decision-making at the KKPPI level.

29. **Anti-Corruption**: As mentioned earlier, Indonesia has adopted far reaching measures to combat corruption. As part of the IRSDP, the Ministry of Public Works – the largest ministry in terms of infrastructure projects – has begun the adoption of an electronic-procurement system. Moving forward, it will adopt an Action Program to combat corruption, focusing on procurement, accountability and transparency, auditing and human resource management. The measures under the Action Program will be implemented over the course of Subprograms 2 and 3 of the IRSDP, subject to adequate progress being made in their formulation.

.IV. Conclusion

29. Indonesia's pre-crisis investments in infrastructure – at around 6% of GDP per annum - matched those of the other large Southeast Asian economies. With regard to PSP in infrastructure provision, while Indonesia may not be an unqualified success, it has not been a complete failure either. We had significant private investments prior to the crisis, which subsequently dried up. The Government clearly recognizes the need to accelerate both public and private investments in infrastructure. The PPP scheme remains our best hope for fulfilling our infrastructure needs in the years to come. We have attempted to incorporate international best practices into our schemes, although, in a gradual manner taking lessons from our past experience. While we have made significant progress thus far, we need to do a lot more to provide a good and predictable operational and legal environment to the private investors.

30. The IRSDP provides us with a framework and implementation support. What we have done so far over 2004-2006 will help the Government in attracting significantly greater PSP over 2006-2009. Reviving infrastructure is not only critical, but absolutely essential, to improve our competitiveness, achieve sustainable economic growth, create jobs for the growing number of unemployed, and overcome poverty. We remain fully committed to the forward looking agenda laid out in the IRSDP to enhance governance, level the playing field, attract private sector investments in a fully transparent manner, and allocate adequate public resources to accelerate infrastructure development. In particular, the overall thrust of promoting PPPs as laid out in regulations such as Perpres No.67/2005, MOF Decree No.38/2005 and other sectoral laws and regulations will be maintained throughout. Likewise, our aim is to continuously enhance coordination amongst the various ministries and agencies to accelerate infrastructure development. For this, we will ensure that there is always a conducive and supportive institutional environment. We are resolved to move ahead, working closely with ADB and other development partners.

Boediono Coordinating Minister for Economic Affairs	Sri Mulyani Indrawati Minister of Finance	Paskah Suzetta Minister for National Development Planning

Table 1: List of Candidate Public Private Partnership (PPP) Projects to be Pursued as Model PPPs

Project	Key Features	Investment ($ million)	Line Ministry/Contracting Agency
Central Java Coal Fired Power Plant	2X600 MW	1,200.0	MEMR/ PLN
Pasuruan Combined Cycle Power Plant	1X500 MW	275.0	MEMR/PLN
Medan-Kuala Namu-Tebing Tinggi Toll Road Project	60 kilometers	142.0	MPW/BPJT
Solo-Kertosono Toll Road Project	165 kilometers	928.0	BPJT
Margagiri-Ketapang Ferry Terminal	1.2 million passengers/annum	97.0	MOT
Teluk Lamong Seaport (Tanjung Perak Port Expansion)	1,280 meter berth container terminal	275.0	MOT
Bandung Water Supply Project	450 liters/second	26.0	Bandung Local Government/ BPP SPAM
Dumai Water Supply Project	500 liters/second	44.0	Dumai Local Government/BPP SPAM
Tangerang Water Supply Project	550 liters/second	37.0	Tangerang Local Government/BPP SPAM
National Telecommunications Backbone Project	30,000 kilometers of fiber optic network	1,500.0*	Ministry of Communications and Informatics
Total		4,524.0	

BPJT - Indonesian Toll Road Authority; BPP SPAM - National Water Regulatory Agency; MEMR - Ministry of Energy and Mineral Resources; MOT - Ministry of Transport; MPW - Ministry of Public Works; PLN - State Electricity Corporation

* - An alternative proposal has also been prepared focusing on creating a backbone network only for the Eastern parts of Indonesia at a cost of $315 million.

POLICY MATRIX FOR THE INFRASTRUCTURE REFORM SECTOR DEVELOPMENT PROGRAM[1]

No	Action	Output/Milestone	SP1	SP2	SP3
I. Cross-Sectoral Policy, Legal and Institutional Framework (BAPPENAS; CMEA; MOF; MOHA; MEMR; MOT; MPW; BPN)					
1.	Establish a framework for PSP that provides for good governance through transparent and competitive selection of project sponsors	1.1 High-level policy statement in support of sector reforms and PPPs at the Indonesia Infrastructure Summit	**X**		
		1.2 Perpres No. 67/2005 on Cooperation Between the Government and Business Entities in Infrastructure Provision (replacement of Keppres No. 7/1998) **[A.1]**	**X**		
		1.3 Operations Guidelines Manual (OGM), elucidating Perpres No. 67/2005, describing rules and procedures for preparing and executing PPP projects, and stipulating that Government support would be considered only if so indicated in the bidding documents **[B.2]**	**X**		
		1.4 CMEA Regulations No.3/2006 on readiness criteria for project prioritization and No.4/2006 on procedures for evaluating projects requiring Government support (indicating that requests for such support should be submitted prior to bidding) **[B.3 and B.4]**	**X**		
		1.5 Sectoral OGMs for PPP projects in infrastructure provision [**B.5**]		X	
2.	Improve coordination among government institutions and consultation with external stakeholders to accelerate infrastructure development	2.1 Perpres No.42/2005 on strengthening the KKPPI mandate **[A.2]**	**X**		
		2.2 CMEA Regulation No.1/2006 on the organizational structure and responsibilities of the KKPPI Secretariat and the PPP Central Unit **[B.7 and B.9]**	**X**		
		2.3 Minister of Transportation Decree No. 270/2006 and Minister of Energy and Mineral Resources Decree No. 2541/2006 on the establishment of the PPP nodes in their ministries **[B14 and B15]**	**X**		
		2.4 KKPPI website with regularly updated information in Bahasa Indonesia and English on PPP project status, and relevant laws and regulations **[B.11]**	**X**		
		2.5 The PPP Central Unit and the PPP nodes operational in terms of functions, budget, staffing and standard operating procedures		X	
		2.6 Review of the KKPPI Secretariat's structure			X
		2.7 Implementations of recommendations of the review			X
		2.8 Establishment of the Consolidated Indonesia Infrastructure Forum (CIIF) for consultations with investors and other stakeholders **[A.4]**	**X**		

[1] SP1 refers to Subprogram 1 covering the period January 2005 to September 2006; SP2 refers to Subprogram 2 covering the period October 2006 to June 2008; and SP3 refers to Subprogram 3 covering the period July 2008 to March 2010. The bold symbols are cross-references to the Government's Infrastructure Policy Package (**A** – completed in 2005; and **B** – scheduled for completion in 2006). Details are at: http://www.kkppi.go.id/kebijakan2006.php?pgstate=Y&enid=&langsel=E&subid=&secid=

No	Action	Output/Milestone	SP1	SP2	SP3
		2.9 Full operationalization of the CIIF in terms of budget, staffing and work program for stakeholder consultations **[B.18]**		X	
3.	Establish a risk management framework to ensure adequate risk mitigation and sharing for projects that require government support	3.1 MOF Regulation No. 518/2005 on the Establishment of Risk Management Committee **[A.3]**	**X**		
		3.2 MOF Regulation No.38/2006 on Risk Management Policy, outlining the criteria (legality, project quality, fiscal prudence and transparency) and procedures for the provision of Government support for PPP projects. **[B.16]**	**X**		
		3.3. Establishment of a permanent Risk Management Unit to evaluate proposals for government support for PPP projects, manage consequent fiscal risks, and propose limits on exposure **[B.17]**	**X**		
		3.4 The Risk Management Unit operational in terms of functions, budget, staffing and standard operating procedures		X	
		3.5 Allocation of resources for government support to PPP projects in the annual budgets	**X**	X	X
		3.6 Establishment of a new guarantee mechanism with adequate resources for risk sharing to enhance PSP		X	
4.	Establish financing mechanisms to support public and private sector portions of infrastructure projects, and adopt measures to broaden and deepen the financial sector, with focus on non-bank financial institutions	4.1 Policy paper on long-term infrastructure financing **[B.19]**	**X**		
		4.2 Concept paper on the establishment of a Project Development Facility (PDF)	**X**		
		4.3 Allocation of resources for the preparation of PPP projects in the draft 2007 budget	**X**		
		4.4 Establishment of the PDF for the preparation of national and regional PPP projects		X	
		4.5 Establishment of the PPP Infrastructure Fund to finance the public sector portion of PPP projects			X
		4.6 Establishment of the Indonesia Infrastructure Fund to finance the private sector portion of PPP projects			X
		4.7 Feasibility study of a municipal infrastructure fund for local government infrastructure		X	
		4.8 Implementation of recommendations of the feasibility study			X
		4.9 Draft Securitization Law, allowing for issuance of asset and mortgage-backed bonds **[B.104]**		X	
5.	Establish a land acquisition framework to facilitate	5.1 Presidential Regulations No.36/2005 and No.65/2006 on Land Acquisition outlining the rules and procedures for infrastructure projects **[A.5 and B.20]**	**X**		

No	Action	Output/Milestone	SP1	SP2	SP3
	infrastructure development	5.2 BPN implementation guidelines for the Presidential Regulations **[B.21]**		**X**	
		5.3 Analysis of gaps between the revised land acquisition framework and international best practices such as the Equator Principles		X	
		5.4 Implementation of recommendations of the gap analysis			X
6.	Adopt legal framework that clarifies the responsibilities of different levels of government in the provision of infrastructure services	6.1 Government Regulation on the assignment of functions among central, provincial, and regional/municipal governments **[B.23]**		X	
		6.2 Implementing regulations for laws in the various infrastructure sectors that are in conformity with the above Government Regulation		X	X
7.	Revise the national policy and legal framework on borrowing from domestic and external sources to give priority to infrastructure development	7.1 Government Regulation No.2/2006 on Foreign Loans and Grants **[B.24]**	**X**		
		7.2. Government Regulation No. 54/2005 on Regional Government Borrowing; Government Regulation No. 55/2005 on On-Lending; and Government Regulation No. 57/2005 on On-Granting **[A.46 to 47]**	**X**		
		7.3 Minister of Development Planning/Chairman of BAPPENAS Regulation No. 5/2005 for planning, proposing, and evaluating projects to be finance by foreign loan/grant, MOF Decree No. 52/2006 and No. 53/2006 for the replacement of MOF Decree No. 35/2003, with criteria for classifying revenue and non-revenue generating projects **[B.25; B.124]**	**X**		
		7.4 Five-year pipeline of projects to be financed by foreign loans or grants	**X**	X	X
8.	Adopt a PSO policy that ensures uniformity across infrastructure sectors	8.1 Policy Paper on PSO in infrastructure provision **[B.26]**		X	
		8.2 Implementation of the PSO policy			X
II. Sector Reforms[2]					
A. Land Transportation (MOT, MPW)					
9.	Undertake long-term planning for land transportation in terms of physical expansion, restructuring, and safety	9.1 Land transportation masterplan **[A.7]**	**X**		
		9.2 Land transportation safety plan **[B.34]**		X	
10.	Revise the legal framework for	10.1 New Law on Road Traffic and Transportation **[B.35]**		X	

[2] The timing of actions and outputs related to sector laws is subject to enactment of such laws by Parliament.

No	Action	Output/Milestone	SP1	SP2	SP3
	land transportation to reflect decentralization and eliminate the SOE monopoly by separating the regulator and operator functions	10.2 Implementing regulations for the new law			X
11.	Adopt appropriate tariff policy in line with the cost recovery principle outlined in Perpres No.67/2005	11.1 Government Regulation/Ministerial Decree on tariff calculation and application **[B.36]**		X	
		11.2 Implementation of the new tariff policy		X	
12.	Adopt measures to improve safety in land transportation	12.1 Establishment of a Directorate of Land Transportation Safety **[A.9]**	**X**		
		12.2 Presidential Regulation on the National Road Safety Board **[B.37]**		X	
		12.3 Establishment of the National Road Safety Board			X
		12.4 Government regulation on vehicle inspections by private sector companies		X	
		12.5 Pilot program on certification, qualification, and accreditation of private sector companies for the new vehicle inspection system			X
13.	Improve roads and traffic management to reduce congestion in the Jakarta-Bogor-Tanggerang-Bekasi (JABOTABEK) area	13.1 Revised Government Regulation on truck and trailer prohibition areas		X	
		13.2 Ministerial Regulation No.14/2006 on traffic demand management policy	**X**		
		13.3 Implementation of road improvement program		X	
14.	Review the current PSO policy for land transportation to make it affordable for the poor, and to increase PSP and service coverage	14.1 Reconfirmed PSO policy framework **[B.38]**		X	
		14.2 Implementation of the PSO policy			X
B. Railways (MOT)					
15.	Undertake long-term planning for the railway sector in terms of physical expansion, modal shift and sector restructuring	15.1 Revised railway sector blueprint **[B.41]**		X	
		15.2 Coal transportation infrastructure masterplan for Kalimantan		X	
		15.3 Railway transportation masterplan for the JABOTABEK area		X	
16.	Revise the legal framework for the railway sector to reflect decentralization and eliminate the KAI monopoly by separating the regulator and operator functions	16.1 Revised Law on Railways **[B.42]**		X	
		16.2 Implementing regulations for the revised law **[B.43]**			X

No	Action	Output/Milestone	SP1	SP2	SP3
17.	Adopt appropriate tariff policy in line with the cost recovery principle outlined in Perpres No.67/2005	17.1 Government Regulation/Ministerial Decree on tariff calculation and application **[B.44]**		X	
		17.2 Implementation of the new tariff policy		X	
18.	Adopt regulatory arrangements for the railway sector that ensure level-playing field for all operators	18.1 Assessment of the current regulatory arrangements in the railway sector		X	
		18.2 Implementation of recommendations of the assessment			X
19.	Improve railway operations and maintenance	19.1 Assessment of management practices of the Railway Operator		X	
		19.2 Implementation of recommendations of the assessment		X	
		19.3 Medium and long-term maintenance program			X
		19.4 Technical standards, procedures and rules for operations			X
		19.5 Government Regulation on train car operation and safety standards			X
20.	Review the current PSO policy for the railway sector to make it affordable for the poor, and to increase PSP and service coverage	20.1 Revised PSO policy framework **[B.45]**		X	
		20.2 Implementation of the revised PSO policy			X
C. Sea Transportation (MOT)					
21.	Undertake long-term planning for sea transportation in terms of physical expansion and restructuring	21.1 Revised sea transportation blueprint **[B.46]**	**X**		
22.	Revise the legal framework for sea transportation to reflect decentralization and eliminate the PELINDO monopoly by separating the regulator and operator functions	22.1 Presidential Instruction (Inpres) No. 5/2005 on the Empowerment of the National Shipping Industry, promoting the separation of the regulatory and operator functions in ports and allowing more than one terminal operator	**X**		
		22.2 Revised Law on Shipping **[B.47]**		X	
		22.3 Ministerial Regulations on the implementation of Inpres No.5/2005 **[B.50]**	**X**		
		22.4 Implementing regulations for the revised Law on Shipping **[B.48]**			X
23.	Adopt appropriate tariff policy in line with the cost recovery principle outlined in Perpres No.67/2005	23.1 Government/Ministerial Regulation on tariff calculation and application **[B.49]**		X	
		23.2 Implementation of the new tariff policy		X	
24.	Adopt regulatory arrangements	24.1 Assessment of the current regulatory arrangements for sea transportation		X	

No	Action	Output/Milestone	SP1	SP2	SP3
	for sea transportation that ensure level-playing field for all operators	24.2 Implementation of recommendations of the assessment			X
25.	Review the current PSO policy for sea transportation to make it affordable for the poor and to increase PSP	25.1 Revised PSO policy framework **[B.51]**		X	
		25.2 Implementation of the revised PSO policy			X
26.	Adopt measures to enhance security in international ports and safety in sea transportation	26.1 Review of security arrangements in international ports **[A.12]**	**X**		
		26.2 Verification and certification of compliance by international ports with the provisions of the 2002 International Shipping and Port Security Code **[B.52]**	**X**		
		26.3 Technical safety and inspection standards for ships		X	
D. Air Transportation (MOT)					
27.	Undertake long-term planning for air transportation in terms of physical expansion and restructuring	27.1 Revised air transportation blueprint **[A.13]**	**X**		
28.	Revise the legal framework for air transportation to reflect decentralization and eliminate the AP monopoly by separating the regulator and operator functions	28.1 Revised Law on Aviation **[B.53]**		X	
		28.2 Implementing regulations for the revised law			X
29.	Adopt appropriate tariff policy in line with the cost recovery principle outlined in Perpres No.67/2005	29.1 Government Regulation/Ministerial Decree on tariff calculation and application **[B.54]**		X	
		29.2 Implementation of the new tariff policy		X	
30.	Adopt regulatory arrangements for air transportation that ensure level-playing field for all operators	30.1 Assessment of the current regulatory arrangements		X	
		30.2 Implementation of recommendations of the assessment			X
31.	Integrate air traffic control services to enhance coordination and safety	31.1 Study on a new air traffic control corporation **[A.17]**	**X**		
		31.2 Implementation of recommendations of the feasibility study		X	
32.	Adopt measures to enhance security in international airports	32.1 Review of security arrangements in international airports **[A.18]**	**X**		
		32.2 Verification and certification of compliance by international and major airports with the regulations of the International Civil Aviation Organization **[B.57]**	**X**		

No	Action	Output/Milestone	SP1	SP2	SP3
33.	Review the current PSO policy for air transportation to facilitate access to remote and disadvantaged areas and increase PSP	33.1 Revised PSO policy framework **[B.56]**		X	
		33.2 Implementation of the revised PSO policy			X
E. Roads (MPW; MOF; MOT; MOHA; BPN)					
34.	Undertake long-term planning for road transportation in terms of rehabilitation and expansion	34.1 Revised blueprint for the national road network **[A.19]**	**X**		
35.	Revise the legal framework for the road sector to reflect decentralization, eliminate the Jasa Marga monopoly by separating the regulator and operator functions	35.1 Government Regulation No. 15/2005 on Toll Roads, providing for the establishment of a new regulatory body, ending Jasa Marga's monopoly, and allowing large-scale PSP **[A.21]**	**X**		
		35.2 Ministerial Decree No. 374/KPTS/M/2005 on toll road tariff setting through competitive bidding	**X**		
		35.3 Minister Regulation No. 22A/2005 on prequalification guidelines, No. 295/2005 on regulatory body, and No. 392/2005 on minimum service standard.**[B.58]**	**X**		
		35.4 Implementing regulations on planning guidelines, technical standards, investment and procurement, land acquisition, and traffic management for toll roads [B.58]		X	
36.	Adopt measures to ensure good governance and combat corruption	36.1 Draft standard bidding documents for public procurement	**X**		
		36.2 Website presenting all projects and activities of the Directorate General of Highways	**X**		
		36.3 Ministerial Decree on the adoption of a transaction-based e-procurement system for all road contracts, including on-line submission of bids and electronic bid opening	**X**		
		36.4 Implementation of the transaction-based e-procurement system		X	
		36.5 Action Program for further anti-corruption measures in the areas of procurement, accountability and transparency, auditing, and human resources		X	
		36.6 Phased implementation of the Action Program		X	X
37.	Adopt regulatory arrangements for road transportation that ensure level-playing field for all	37.1 Establishment of BPJT as a separate regulatory body **[A.22]**	**X**		
		37.2 BPJT operational in terms of functions, budget, organizational structure, staffing and standard operating procedures **[B.59]**	**X**		

No	Action	Output/Milestone	SP1	SP2	SP3
	operators	37.3 Review of the contracting and regulatory functions and reporting arrangements of BPJT			X
		37.4 Implementation of recommendations of the review			X
38.	Adopt a land acquisition mechanism that facilitates the execution of PPP projects	38.1 Initial concept of a revolving fund for land acquisition **[B.61]**	**X**		
		38.2 Establishment of the revolving fund for land acquisition, including institutional arrangements **[B.62]**		X	
39.	Adopt measures to provide sustained funding for road preservation and to link it to road use	39.1 Review of the current system of road user charges and socialization of the Road Fund concept **[B.64]**			
		39.2 Implementation of recommendations of the review/socialization			
40.	Adopt measures to improve road maintenance	40.1 Adequate budget allocation for routine maintenance of national roads		X	X
		40.2. Design of performance-based contracting for road maintenance and vehicle load control **[B.65]**		X	
		40.3 Pilot program for the performance-based contracts		X	
		40.4 Country-wide expansion of the pilot program			X
F. Power (MEMR; PLN; BKPM)					
41.	Undertake long-term planning for the power sector in terms of physical expansion, service coverage and sector restructuring	41.1 Revised power sector masterplan (RUKN) **[A.24]**	**X**		
		41.2 Revised power development plan (RUPTL), incorporating the recently announced crash program for coal-fired power plants **[A.25]**		X	
		41.3 Institutional and financing strategy for meeting the Government's electrification targets		X	
		41.4 Implementation of the electrification strategy			X
42.	Revise the legal framework for the power sector to remove the uncertainty caused by the annulment of Law No. 20/2002 on Electricity by the Constitutional Court	42.1 Government Regulations No. 3/2005 and 26/2006, and related ministerial decrees enabling the purchase of electricity from independent power producers by PLN **[A.28]**	**X**		
		42.2 New Law on Electricity **[B.70]**		X	
		42.3 Implementing regulations for the new Law on Electricity			X
43.	Strengthen PLN's institutional structure and capacity in the areas of project planning and implementation, financial management, and corporate governance	43.1 Report on corporate restructuring of PLN		X	
		43.2 Implementation of recommendations of the report			X

No	Action	Output/Milestone	SP1	SP2	SP3
44.	Adopt appropriate tariff policy for PLN customers in line with the cost recovery principle outlined in Perpres No.67/2005	44.1 Strategy for achieving full cost recovery by PLN through further efficiency improvements, tariff increases, and transparent subsidies	**X**		
		44.2 Implementation of the full cost recovery strategy		X	X
		44.3 Review of the tariff structure and tariff setting process, including the viability of an automatic tariff adjustment mechanism			X
45.	Adopt regulatory arrangements for the power sector that are consistent with the new legal framework and aim at economic regulation	45.1 Assessment of the current regulatory arrangements		X	
		45.2 Implementation of recommendations of the assessment			X
46.	Review the current PSO policy for the power sector to make it affordable for the poor, and to increase PSP and service coverage	46.1 Revised PSO policy framework **[B.73]**		X	
		46.2 Implementation of the revised PSO policy			X
47.	Improve the investment climate for independent power producers	47.1 Assessment of the current regulations on minimum local ownership, such as Government Regulation No.20/1994, as well as taxes and duties, and recommendations to the Investment Coordinating Board (BKPM)		X	
		47.2 Implementation of recommendations of the assessment by BKPM			X
G. Oil and Gas (MEMR; BPH MIGAS)					
48.	Undertake long-term planning for the oil and gas sector in terms of physical expansion	48.1 Revised blueprint for natural gas pipeline network **[B.67]**		X	
		48.2 Oil infrastructure masterplan **[B.68]**		X	
49.	Amend the legal framework for the oil and gas sector to address concerns of the Constitutional Court about domestic market obligation and pricing, while preserving downstream competition	49.1 Revised Government regulations for Law No. 22/2001 on Oil and Gas **[B.69]**		X	
50.	Adopt a legal framework for the energy sector that ensures energy security through diversification of energy sources and energy conservation	50.1 Perpres No.5/2006 on national energy policy, stipulating an increased share of natural gas in the energy mix **[A.30]**	**X**		
		50.2 Ministerial Decree No. 1503/2006 establishing a team comprising DG Migas, BPH Migas, and PLN to coordinate gas supply policy	**X**		
		50.3 Ministerial Regulation No. 33/2006 on coal bed methane (CBM) development	**X**		
		50.4 New Energy Law **[B.71]**		X	
		50.5 Implementing regulations for the new Energy Law **[B.72]**			X
51.	Introduce competition in oil	51.1 Dismantling of Pertamina monopoly in the retail market	**X**		

No	Action	Output/Milestone	SP1	SP2	SP3
	product distribution, and adopt market-based pricing to remove government subsidies and energy mix distortions	51.2 Oil price adjustments of March and October 2005	**X**		
		51.3 Further oil price adjustments for premium oil products	**X**		
		51.4 Completion of the oil subsidy removal		X	
		51.5 Implementation of an automatic oil price adjustment mechanism			X
52.	Adopt regulatory arrangements for the oil and gas sector that are consistent with the amended legal framework and aim at separating the policy-making, contracting and regulatory functions	52.1 BPH Migas operational in terms of functions, budget, organizational structure, staffing and standard operating procedures		X	
		52.2 Assessment of the current regulatory arrangements		X	
		52.3 Implementation of recommendations of the assessment			X
H. Telecommunications (MCI)					
53.	Undertake long-term planning for the telecommunications sector in terms of physical expansion and restructuring	53.1 Revised telecommunication blueprint **[B.76]**		X	
54.	Transform the telecommuni-cations sector from the current duopoly to full market competition	54.1 Business opportunities opened for fixed-line long-distance and international connections		X	
55.	Revise the legal framework for the sector to reflect changes in the industry structure	55.1 Ministerial Regulation No. 8/2006 on Interconnection, providing for a move from revenue-sharing to a cost-based approach to tariff setting **[B.78]**	**X**		
56.	Adopt new industry structure and regulatory arrangements for the sector that aim at economic regulation	56.1 BRTI operational in terms of functions, staffing, organizational structure, budget, and standard operating procedures **[B.80]**	**X**		
		56.2 Design of a new telecommunications industry structure **[B.79]**		X	
		56.3 Restructuring of the telecommunication licensing system		X	
		56.4 Implementation of the new telecommunications industry structure and licensing system			X
57.	Review the current USO policy for the sector to increase PSP and service coverage	57.1 Government Regulation No. 28/2005, allocating part of telecommunications companies' revenues for USO **[A.32]**	**X**		
		57.2 Implementation of the new USO policy		X	
I. Water Supply and Sanitation (MPW; BAPPENAS; MOF; MOHA)					
58.	Undertake long-term planning for the water supply and	58.1 Policy on community-based water supply and environmental sanitation **[A.36]**	**X**		
		58.2 Policy on institutionally based water supply and environmental sanitation		X	

No	Action	Output/Milestone	SP1	SP2	SP3
	sanitation sector in terms of physical expansion and restructuring	58.3 Ministerial Decree on water supply, outlining a strategy for increasing access to water and identifying mechanisms and incentives to achieve the Government's access targets **[B.88]**		X	
		58.4 Ministerial Decree on wastewater, outlining a strategy for increasing access to sanitation and identifying mechanisms and incentives to achieve the Government's access targets **[B.88]**		X	
		58.3 Ministerial Decree on solid waste management, outlining a strategy for increasing access to environmental sanitation and identifying mechanisms and incentives to achieve the Government's access targets **[B.88]**		X	
59.	Adopt measures to enhance PDAMs' transparency, improve their operational efficiency and financial viability, and expand their service coverage	59.1 Publication of technical and financial information on PDAMs, including the number of functioning connections and arrears, on a BPP SPAM website		X	X
		59.2 Design of a pilot program for PDAM debt restructuring, commercialization, consolidation, water loss reduction, and service expansion		X	
		59.3 Implementation of the pilot program		X	
		59.4 Country-wide expansion of the pilot program		X	X
60.	Further increase service coverage through community schemes, other institutional mechanisms, and PSP	60.1 Design of a non-PDAM rural and urban water service expansion program, which is in line with the Ministerial Decree issued under 56.3, and includes performance-based provision of earmarked transfers (DAK)		X	
		60.2 Implementation of the water service expansion program			X
61.	Revise the legal framework for the water supply and sanitation sector to reflect decentralization and eliminate the PDAM monopoly	61.1 Government Regulation No. 16/2005 on Water Supply, eliminating the need for local parliament approvals of tariff increases, clarifying the terms for PSP, and providing for the establishment of a new regulatory body **[A.38]**	**X**		
		61.2 New Law on BUMDs, providing for greater managerial autonomy of PDAMs vis-à-vis local governments		X	
		61.3 Other implementing regulations for Law No.7/2004 on Water Resources and Government Regulation No.16/2005 **[B.90 to 92]**		X	
62.	Improve management of water catchment areas to ensure adequate supply and quality of raw water	62.1 Establishment of the National Movement for Water Conservation Partnership (GN-KPA) **[A.41]**	**X**		
63.	Adopt appropriate tariff policy that ensures full cost recovery	63.1 Ministry of Home Affairs Decree No. 23/2006 on Drinking Water Tariff Policy providing for cost recovery and reduction in consumer categories **[B.96]**	**X**		
		63.2 Implementation of the new tariff policy by local governments		X	
64.	Adopt regulatory arrangements that separate the policy making, regulatory, contracting and	64.1 Establishment of BPP SPAM **[A.39]**	**X**		
		64.2 Review of the current regulatory arrangements and assessment of the suitability of BPP SPAM to act as an independent regulator **[B.97]**		X	

No	Action	Output/Milestone	SP1	SP2	SP3
	operational functions	64.3 Implementation of recommendations of the review/assessment			X
65.	Develop a PSO policy for raw water, drinking water, sanitation and solid waste	65.1 PSO policy framework **[B.102]**		X	
		65.2 Implementation of the PSO policy			X
III. Project Transactions (MCI; MEMR; MOT; MPW; PLN; BPJT; BPH Migas)					
66.	Build up and maintain a strong PPP project pipeline based on sectoral masterplans and blueprints	66.1 List of 91 infrastructure projects issued at the first Indonesia Infrastructure Summit	**X**		
		66.2 Updated rolling pipeline of PPP projects		X	X
67.	Review the current bidding and contract documents, revise them to incorporate international best practices, and publish them in English	67.1 Standard bidding documents and concession agreement for toll roads		X	
		67.2 Standard bidding documents and power purchase agreement for power plants		X	
		67.3 Standard bidding documents and gas transmission license for gas pipelines		X	
		67.4 Standard bidding documents and water supply license for water supply projects		X	
		67.5 Standard bidding documents and concession agreements for airport and projects		X	
68.	Prioritize the PPP projects and in line with Perpres No.67/2005, undertake rigorous pre-feasibility studies, including an estimate of the type and level of Government support, if any	68.1 Model projects selected by the KKPPI in the various infrastructure sectors for preparation and execution in line with Perpres No. 67/2005, CMEA Regulations No. 3 and 4/2006, and MOF Regulation No. 38/2006	**X**		
		68.2 Funds allocated and preparation of Information Memorandums for the model projects started for distribution at the second Indonesia Infrastructure Summit	**X**		
		68.3 Preparation of the model projects completed		X	
		68.4 Preparation completed for further projects selected by the KKPPI		X	X
69.	Subject to a positive outcome of the pre-feasibility studies, select private sector partners through a transparent and competitive bidding process	69.1 Call for bids for the model projects		X	
		69.2 Call for bids for the projects mentioned under No.68.4		X	X
		69.3 Preferred bidders for the projects mentioned under 68.1 and 68.2 determined		X	X

BAPPENAS = National Development Planning Agency; BPJT = Indonesian Toll Road Authority; BP Migas and BPH Migas = gas contracting and regulatory bodies; BPN = National Land Agency; BPP-SPAM = National Water Regulatory Agency; BRTI = Indonesian Telecommunications Regulatory Body; CIIF = Consolidated Indonesia Infrastructure Forum; CMEA = Coordinating Ministry of Economic Affairs; JABOTABEK = Jakarta-Bogor-Tanggerang-Bekasi; KKPPI = National Committee on the Acceleration of Infrastructure Development; MCI = Ministry of Communications and Informatics; MEMR = Ministry of Energy and Mineral Resources; MOF = Ministry of Finance; MOHA = Ministry of Home Affairs; MOT = Ministry of Transport; MPW = Ministry of Public Works; OGM = operations guidelines manual; PDAM = regional water supply company; PDF = Project Development Facility; PELINDO = Indonesian Port Corporation; Perpres = Presidential Regulation; PPP = public-private partnership; PSO = public service obligation; PT KAI = Indonesian Railway Corporation; PT PLN = State Electricity Corporation; RUKN = power sector masterplan; RUPTL = power sector development plan; SOE = state owned enterprise; USO = universal service obligation.

PRINCIPAL OUTCOMES TO DATE UNDER THE INFRASTRUCTURE REFORM SECTOR DEVELOPMENT PROGRAM

Theme	Action	Achievements Until September 2006
A. Cross-Sector Reforms		
Good Governance	Establish a framework for PSP that provides for good governance through transparent and competitive selection of project sponsors	Presidential Regulation 67/2005 adopted; full implementation could greatly facilitate good governance
	Improve interministerial/agency coordination	KKPPI strengthened; PPP central unit and nodes being established
Risk Sharing	Establish a risk management framework and decide on risk sharing	MOF Decree 38/2006 issued; Risk Management Unit established; resources allocated in the 2006 budget; "negative" transactions rejected, and 2–3 "positive" transactions under consideration
Financing	Establish infrastructure financing mechanisms	Framework developed for the Project Development Facility, and Indonesia Infrastructure Fund; Guarantee Fund being designed
Land Acquisition	Resolve land acquisition and resettlement issues	Increasing convergence between Indonesian and international practices
Decentralization	Clarify functional assignments between different levels of governments	Resolution in most areas, regulation to be adopted later
	Strengthen legal framework on borrowing, and adopt a streamlined project catalogue system	Legal framework adopted, with an annual and a 5-year catalogue of projects
Public Service Obligation (PSO)	Adopt and implement a consistent and sustainable PSO policy framework to make infrastructure services affordable for the poor	Basic policy paper developed
B. Sector-Specific Reforms		
Long-Term Strategic Planning	Adopt master plans, blue prints, and strategies aimed at physical expansion, improving access, restructuring, and modal shift	Master plans prepared in all sectors; in the power sector, an accelerated program developed
Legal Framework	Revise laws and regulations to remove SOE monopoly and ensure greater private sector participation	Laws allowing separation of regulator and operator functions and phasing out of SOE monopoly in the transport sectors in Parliament; implementing regulations adopted for PSP in roads and water supply and sanitation
Tariff Policy	Gradually move to full-cost recovery	Good progress in the water, land transportation, and toll-road sectors; electricity tariffs politically sensitive.
Regulatory Framework	Review and modify regulatory arrangements to ensure level playing field (equal access and opportunities) for all operators	Regulatory bodies, though not yet fully independent, established in the toll-road, oil and gas, telecommunications, and water supply and sanitation sectors
Transparency	Undertake measures to infuse good governance in procurement and overall project implementation	Standard bidding documents drafted. E-procurement adopted in the road sector on a pilot basis
Miscellaneous	Adopt measures to improve safety and security, and rationalize costs	Institutional mechanisms in place for land and air transportation
C. Translating Reforms into Actions; Public Private Partnership (PPP) Project Transactions		
Bidding Process	Adopt international best practices through standard bidding documents, concession agreements, PPAs, and gas transmission licenses	Toll roads and power documents drafted and being used.
Model PPP Projects	Prioritize and draw up a realistic list of model PPP projects, allocate resources for their preparation, and proceed with competitive bidding	Several candidate model PPPs adopted and preparation initiated; to be announced at the November 2006 Infrastructure Conference

KKPPI = National Committee on the Acceleration of Infrastructure Development; MOF = Ministry of Finance; PPA = power purchase agreement; PPP = public-private partnership; PSO = public service obligations; PSP = private sector participation; SOE = state-owned enterprise. Source: Asian Development Bank staff.

DEVELOPMENT PARTNERS COORDINATION MATRIX

Type of Reform	Subject/Sector	Asian Development Bank	Other Development Partners
Cross-Cutting	Institutional strengthening	• Power Sector Restructuring Program (completed) • Ongoing Community Water Supply and Health Project • Ongoing technical assistance (TA) to the National Committee on Acceleration of Infrastructure Development (KKPPI)	• World Bank support to the KKPPI and other selected line ministries under its ongoing Private Participation in Infrastructure TA • Various loan and TA projects of the Japan Bank for International Cooperation (JBIC)
	Risk management	• Proposed TA under the IRSDP	• Ongoing TA from Australian Agency for International Development (AusAID) • Proposed JBIC TA
	Nonbank financial sector (NBFS) development	• Financial Governance and Social Security Reform Program; and ongoing TA to the Ministry of Finance and Capital Market Supervisory Agency	• World Bank TA on NBFS product development • Support from the Government of the Republic of Korea to develop the secondary bond market • JICA support for capital market reforms • AusAid support for NBFS development
	Local governments and their public enterprises	• Ongoing Local Government Finance and Governance Reform Sector Development Program and related TAs	• Canadian International Development Agency TA • World Bank loans and TA
Sector-Specific	Transportation	• Proposed port and airport projects • Proposed toll-road projects	• Various ongoing and planned projects from JBIC
	Power	• Power Sector Restructuring Program (completed) • Proposed Energy Efficiency Project • Proposed private sector power generation projects	• Various ongoing and planned projects of JBIC • World Bank loans and TAs
	Oil and Gas	• Proposed public and private sector gas pipeline projects	• USAID TA • JBIC support
	Water Supply and Sanitation	• Ongoing Community Water Supply and Health Project • Proposed regional water supply company (PDAM) Restructuring Project	• World Bank's proposed PDAM Restructuring Project • JBIC's planned projects

Source: Asian Development Bank.

Indonesia—Assessment Letter for the Asian Development Bank
October 23, 2006

Staff Assessment of Developments and Policies

Recent Developments and Short-Term Prospects

After the recent slowdown, GDP growth has begun to recover. Following the significant hike in interest rates and fuel price increases in the fall of 2005, real GDP growth slowed to under 5 percent in the last quarter of 2005 and first quarter of 2006 (y/y). However, growth picked up to 5.2 percent (y/y) in the second quarter, mainly reflecting strong external demand and some acceleration in public consumption. Though still weak, private consumption appears to be picking up, indicating that the adjustment to the domestic fuel price hike last fall is nearly complete. Nevertheless, unemployment is edging up and poverty rates remain high. Growth is expected to pick up gradually over the course of 2006 and in 2007, with IMF staff projecting annual growth to reach 5.2 percent and 6 percent, respectively, as interest rates are reduced. *Nevertheless, there are risks to this outlook, most importantly a weakening of the international environment and slow implementation of structural reforms*.

Inflationary pressures have been declining. Headline inflation declined to 14.6 percent (y/y) in September, from 17.1 percent at end-2005, reflecting weak activity and some appreciation of the rupiah. Meanwhile, three-month annualized inflation (both headline and core) has remained below 6 percent since the beginning of the year. On current trends, Bank Indonesia's (BI's) end-year target of 7–9 percent for headline inflation is well within reach.

The overall banking sector continues to perform reasonably well. Partly due to reclassification, nonperforming loans (NPLs) increased substantially in 2005, especially at the two largest state banks, but the rise in NPLs moderated in January–June 2006. The sharp deceleration in credit growth in 2006, as a result of high interest rates and weak demand, will to some extent undermine bank profitability, but the expected reduction in interest rates should prevent excessive adverse effects on banks. Capital adequacy ratios remain at over 20 percent.

External vulnerabilities continue to be reduced. The current account is expected to remain in surplus in 2006. Foreign exchange reserves, at about $39 billion after the repayment of remaining debt to the Fund of $3¼ billion on October 12, are equivalent to about 130 percent of short-term debt. The current account is expected to move into small deficit over the medium term as imports rise faster than exports, financed in large part by private sector capital inflows. The ratio of external debt to GDP is expected to be reduced to below 25 percent of GDP in 2011, from 48 percent of GDP in 2005. Nevertheless, the market volatility experienced in May/June 2006 is a reminder that Indonesia remains susceptible to adverse developments in international capital markets.

Macroeconomic and Structural Policies

The budgeted policy stance is broadly appropriate. The fiscal deficit targets of 1.3 percent of GDP for 2006 and 0.9 percent of GDP for 2007, as outlined in the President's budget speech in

mid-August, are appropriately geared to further reducing the debt burden, to below 30 percent in 2010 (compared with 47 percent at end 2005), while supporting activity in 2006. After considerable under spending in 2005 and the first quarter of 2006, budget execution improved in the second quarter of 2006.

Monetary policy continues to be geared to reducing inflation. BI's gradual approach to reducing its policy rate has helped contain inflationary pressures and increase foreign exchange reserves. There should be room for further gradual rate cuts given the benign inflation outlook and still large differential with U.S. interest rates, though the authorities need to be careful that excessive rate decreases do not undermine their credibility and prospects for achieving the 2007 inflation target of 5–7 percent. The clarity and consistency of statements by BI officials in signaling the central bank's policy intentions, within the inflation targeting framework, has improved and is essential to maintaining credibility.

Steps are being taken to deal with NPLs at state banks. The recently signed Presidential decree allowing state banks to provide haircuts on loans, together with stepped-up efforts to enforce collections, should help to resolve the NPL problem, and avoid erosion of bank capital. IMF staff continue to advise that medium-term strategies be adopted for the state banks, which should involve privatizing those that do not have a clear public policy objective. As regards private banks, supervisors will need to remain vigilant to enforce regulations, and to monitor any deterioration in credit quality.

The government is proceeding on a broad range of fiscal reforms. Adoption of the tax package now before Parliament, along the lines endorsed by the business community, as well as modernization of the tax department, will help enhance revenue collection while restoring investor confidence. The government's intention to better manage potential risks stemming from the operations of public enterprises and private-public partnerships is welcome.

To improve the business climate and boost growth, the government has prepared an impressive reform agenda. Given the business community's concerns about implementation, some major early reform successes are needed to increase confidence that the entire package will be implemented. The government's efforts to secure early approval of customs, investment, and tax laws are welcome, which apart from the signaling effect would also bring immediate benefits for trade and investment.

Fund staff recognizes the difficulties of amending labor legislation. Staff supports the authorities' intention to press ahead with the introduction of regulations that ensure a balanced framework for labor-business relations. The new regulations need to protect the rights of workers, while enhancing flexibility for business, in particular with regard to severance pay and outsourcing requirements. More flexible labor markets will help Indonesia become more competitive vis-à-vis neighboring countries and should encourage employers to make hiring decisions more freely.

Status of IMF Relations

- Indonesia’s Extended Arrangement with the Fund expired in December 2003. It was followed by a close policy dialogue with the authorities through post-program monitoring (PPM) (until the recent repayment of all obligations to the Fund) and extensive technical assistance activities.

- The 2006 Article IV consultation and fifth PPM were completed on July 31.

- The next Fund mission is scheduled for early December, and technical assistance missions from the Fiscal Affairs Department and the Monetary and Capital Markets Department will be in the field during November.

- The Fund welcomes Indonesia's early repayment of its obligations to the Fund. This is a reflection of the strength of the economy and especially, its balance of payments position. The Fund expects to continue a constructive dialogue with the Indonesian authorities through regular staff visits, technical assistance missions, and in the context of the annual Article IV consultations, the next of which is scheduled for mid-2007.

INELIGIBLE ITEMS

1. The proceeds of the loan will be used to finance the foreign currency expenditures for the reasonable cost of imported goods required during program implementation.

2. Notwithstanding the provision of para. 1, no withdrawals will be made for

(i) expenditures for goods included in the following standard International Trading Commodity chapters or headings:

Table A6: Negative List

Group	Subgroup	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitutes)
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ores and concentrates)

(ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;

(iii) payments made for expenditures incurred more than 180 days before the effectiveness date of the loan;

(iv) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or agreed to finance, including any contract financed under any loans from the Asian Development Bank;

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

(vi) expenditures for narcotics; and

(vii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification.

INFRASTRUCTURE PROJECT DEVELOPMENT FACILITIES

A. Background

1. The lack of adequate preparation of public-private partnership (PPP) projects is one of the most critical impediments affecting infrastructure development in Indonesia. While more than 90 projects were offered to the private sector at the Indonesia Infrastructure Summit in January 2005, the progress in actually implementing these projects has been disappointing. For example, no more than six potential investors showed interest in any of the toll-road projects announced for prequalification; frequently the number has been between zero and two. The absence of adequate and reliable technical and financial information on PPP projects, particularly any detailed analysis of the various risks affecting them, has been the main reason for this low interest and contributed to the Government's unwillingness to provide any risk-sharing support. Without the possibility of such support, reputable investors, especially international, continue to stay away.

2. With recent enhancements to the legal, regulatory, and institutional framework introduced within the broader context of the Asian Development Bank (ADB)-supported Infrastructure Reform Sector Development Program, a more supportive environment for effective private sector participation in infrastructure development has been created. It is in particular the Presidential Regulation (Perpres) 67/2005 on Private Sector Participation in Infrastructure Provision that provides greater certainty to private investors by clearly defining the rules and regulations. However, large-scale private sector participation will remain constrained in the absence of comprehensive and reliable information on PPP projects, and a clear attribution of project risks to parties that are most suitable to manage them. The Government's risk management framework, as outlined in the Ministry of Finance (MOF) Decree 38/2006, deals with the latter. To address the lack of adequate project preparation, which also hampers effective risk allocation, the Government asked ADB to support the establishment of an infrastructure project development facility (PDF).[1] The proposed Project has three components:

(i) PPP project preparation and transaction execution, which includes developing

   (a) a national component of the PDF (NPDF) to fund the preparation and bidding of large projects, mostly in power, toll-road and transport sectors; and
   (b) a regional component of the PDF (RPDF) to fund the preparation and bidding of smaller decentralized regional infrastructure projects.[2]

(ii) technical advisory services to the PDF and capacity building for PPP project promotion and execution; and

(iii) procurement and administrative services to the PDF.

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[1] The PDF will help address one of the most critical constraints. This needs to be supplemented by an effective enforcement of Perpres 67/2005 and other relevant regulations to create equal access for the private sector, and enhance judicial certainty and adherence to arbitration awards or outcomes of dispute resolution mechanisms.

[2] The Government's request for support dates back to 2001. A project preparatory technical assistance (TA) for the private sector participation development facility was implemented from September 2002 to June 2003, the TA loan fact-finding and appraisal missions concluded their work in mid-2005, and all other steps were completed by October 2005 in preparation for loan negotiations. However, in June 2006, the Government requested that the facility's focus, scope, and support be expanded to include the NPDF as well, and that the name of the facility be changed to "RPDF" to reflect the focus on regional decentralized projects, with the NPDF dedicated to national projects.

3. Perpres 67/2005 provides the legal framework for all projects—those that are the responsibility of the national Government, contracting agencies, and local governments. Hence, the PDF will integrate the oversight, technical advisory, and procurement functions for national as well as regional projects, which will result in efficiency gains and conserve resources. Based on the Government's request, ADB proposes providing a loan of $30 million equivalent from ADB's Special Funds resources. The Government of the Netherlands will provide grant cofinancing of $7.5 million, while the Government of Indonesia and concerned local governments will contribute the remaining $7.8 million of the total cost of the PDF.

B. Project Description

1. PPP Project Preparation and Transaction Execution

a. NPDF

4. **Objective and Scope**. The principal objective of the NPDF is to accelerate national PPP project transactions. In line with Perpres 67/2005, the NPDF will provide funding for project preparation and transaction execution, leading to the conclusion of an appropriate contractual arrangement for the project (i.e., PPP procurement).[3] The subsequent project implementation will not be financed from the NPDF. The NPDF will cover large national projects, with specific focus on the power, toll-road and selected transport subsectors. The extent of local government involvement in these projects will be limited in comparison with the RPDF. Given the relatively low access to infrastructure services in Indonesia, particularly of the poor, the NPDF will help the Government's poverty reduction efforts by accelerating necessary investments and encouraging private sector participation, which in turn will have longer term multiplier effects on poverty reduction. Further, the NPDF will alleviate acute capacity constraints within line ministries and contracting agencies in preparing projects and selecting private sector partners.

5. **Functions**. The key functions of the NPDF include

(i) providing support to the National Committee on the Acceleration of Infrastructure Development (KKPPI) in evaluating potential PPP projects based on an objective identification, screening, and prioritization system;
(ii) enhancing awareness of the private sector about PPP projects to solicit interest, establish contacts with potential private project partners, and share information with them, with the view to reducing the cost of infrastructure services through greater competition;
(iii) contracting out consulting and PPP transaction advisory services in an open, transparent, and competitive manner that is fully in line with the Government's procurement regulations;[4]
(iv) overseeing the preparation of prefeasibility studies, preliminary design, and specifications for PPP projects;
(v) providing support for the PPP procurement process, including all aspects such as bidding, negotiation, and contract award; and

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[3] PPP procurement includes prequalification, bidding, negotiation, and signing of the concession agreement with the private sector partner (or other contractual arrangements such as management, leasing, and build-own-operate contracts).

[4] Presidential Decree 80/2003 on Public Procurement. The provisions of the decree, drafted under an ADB technical assistance, are in line with ADB's *Guidelines on the Use of Consultants*. The Decree requires the establishment of a procurement committee, which may comprise members from different line ministries and/or agencies to ensure good governance.

(vi) designing a sustainable cost-recovery scheme to ensure that the project preparatory and transaction execution resources invested through the NPDF are recouped through the PPP contractual agreements, and that a legally sound institutional and operational system is established for the NPDF and government budget system to reuse the recovered resources for the preparation and transaction execution of a continuing pipeline of projects.

6. **Role**. Project preparation and transaction advisory support will include

(i) refining and strengthening PPP project proposals, and preparing a project summary and business plan (information memorandum) aimed at attracting private sector interest;
(ii) identifying sources of technical services that can help prepare quality projects;
(iii) undertaking a thorough prefeasibility study in line with Perpres 67/2005 that includes

(a) preliminary technical design and specifications;
(b) analysis of PPP options leading to the optimum institutional structure to achieve financial closing, and to ensure successful project construction, management, and operation;
(c) a comprehensive economic analysis;
(d) a comprehensive financial analysis, including tariff analysis and testing for project robustness;
(e) detailed cost estimates and a financing plan;
(f) design of a sound fiduciary management structure for the project that promotes transparency between the public and private partners in the PPP transaction;
(g) a comprehensive procurement plan;
(h) a social and environmental impact analysis, including poverty, land acquisition, resettlement, indigenous peoples, and environment; and
(i) assessment of any labor-related concerns or issues, particularly in the case of nongreenfield projects; and

(iv) providing transaction execution services for PPP procurement including

(a) drafting or refining prequalification and bidding documents, and concession agreements (or other contractual arrangements [footnote 3]), which cover, among others, construction, input supply, output purchase, general project management, and management and turnover of assets;
(b) prequalifying bidders;
(c) evaluating technical and financial proposals from prequalified bidders;
(d) ensuring that principles and modalities are specified in the concession agreement for arbitration or other forms of dispute resolution that are applicable within relevant laws to resolve any conflicts or disputes that may arise between the contracting authority and the winning bidder; and
(e) undertaking negotiations with the preferred bidder and finalizing the concession agreement.

7. **Structure and Process**. The NPDF will initially be established, together with the RPDF, as an advisory facility within the Government.[5] Figure A8 presents the various steps involved in project identification, prioritization, selection, preparation, and transaction execution; and shows how the NPDF and RPDF are integrally involved in the process. The steps provide for adequate checks and balances to ensure that BAPPENAS (the National Development Planning Agency), the Executing Agency, as well as the concerned implementing agencies adhere to good governance principles in all aspects related to the PDF, including transparent decision-making on requests for funding from the NPDF and RPDF; procurement of advisory, consulting, and transaction-execution services; and oversight of the project preparation and transaction execution processes. The table at the end of this appendix (Table A8.4) presents a checklist of the regulatory requirements for PPP projects. Once the decision is taken to provide preparatory and transaction execution support from the national or regional component of the PDF, the checklist in Table A8.4 will form the basis for determining the level and scope of such support, as well as for the subsequent decision-making on the PPP project by the KKPPI and MOF.

8. **Project Pipeline and Selection**. The KKPPI Secretariat maintains and regularly updates a database on PPP project opportunities in the various infrastructure sectors, which represents the potential project pipeline for the NPDF. In the July 2006 update, 75 national projects were listed. About half were still at the preparation and prequalification stages, and hence suitable for NPDF funding. The other projects have already reached the bidding or contract award stage, but questions on how many of these will actually materialize are being raised. The bidding was frequently based on inadequate information such as outdated prefeasibility studies (or no studies at all), and the Government did not offer any risk sharing. For such failed projects, rebidding may be needed after the project information, including risk analysis, has been improved, preferably with the help of the NPDF.

9. The power and toll-road sectors account for more than 70% of the country's infrastructure needs. Yet, these are also the sectors where project preparation has not been given adequate resources. The NPDF is expected to finance the preparation and transaction execution for at least 10 power, toll-road, as well as selected transport sector projects. The first two projects, preferably one each for power and toll-roads, will be processed for the NPDF on a model basis. Lessons from other PPP projects prepared and executed outside the NPDF will be reviewed to refine the models. Parallel to that, a cost-recovery scheme may be formulated and adopted through which the Government recoups at least part of the preparatory and execution costs from project sponsors. Subject to the success of the cost-recovery scheme, the number of projects financed by the NPDF may be higher.

10. As shown in Figure A8, the line ministries or contracting agencies will prioritize their projects for funding under the NPDF. In doing so, they will use the prioritization criteria specified in the Government's Operational Guidelines Manual on the application of Perpres 67/2005. Given the limited resources available, BAPPENAS will have to undertake the subsequent ranking and selection of projects for the NPDF in an objective and systematic manner, taking into account the following: (i) inclusion of the proposed project in the concerned ministry or contracting agency's master plan and in the KKPPI database; (ii) quality of the demand forecast or other studies indicating the need for the project; (iii) a rapid preliminary assessment of the technical, economic, and financial prospects of the project vis-à-vis other candidates; (iv) private sector interest, including an assessment of the project's prospects, vis-à-vis other candidates, for attracting wide

[5] Law 1/2004 on the State Treasury allows the Government to establish Badan Layanan Umum or s that can act on behalf of the Government. The possibility of adopting a general service agency status for the PDF will be reviewed as part of the technical advisory services and capacity-building component.

international private sector participation if a comprehensive prefeasibility study is prepared using NPDF resources; (v) completion of all necessary initial steps in line with Perpres 67/2005, including public notification; (vi) submission by the line ministry or contracting agency of a comprehensive proposal request for consulting services for project preparation and transaction execution, with a written and binding commitment that they have complied with all applicable national laws, regulations, and policies; and all relevant environmental and social safeguard requirements; (vii) resource requirements for the consulting services, availability of counterpart support, and commitment from the line ministry/contracting agency to provide such support; (viii) prospects for meeting initial public investment requirements for project implementation, such as land acquisition; and (ix) the need for Government risk-sharing support for project implementation and/or operation. These project selection criteria will be refined under the technical advisory services and capacity-building component.

b. RPDF

11. **Objective**. The RPDF is to support local governments in preparing decentralized regional infrastructure PPP projects effectively to increase private sector participation. The impact of the RPDF will be improved regional living conditions and economic development through local infrastructure development. The outcome will be to (i) increase private sector participation in regional infrastructure projects by enabling local governments to prepare bankable PPP projects, and (ii) disseminate and catalyze best practice in structuring and executing PPP transactions. The resulting projects will be ready for financing and implementation. They will also generate business and employment opportunities for a wide range of private sector participants across Indonesia.

12. **Scope and Function.** The demand assessment for the RPDF is based on 72 projects prioritized by financial viability and implementation capacity from 130 projects identified through consultations with a number of local governments across the country. Financing structures for the projects will vary but, based on experience to date, the large majority will be structured around a local investor contributing some equity, but majority-funded on a recourse basis by national financial institutions (probably commercial banks). The RPDF will facilitate linkages to investors and financial institutions.

13. The RPDF will provide funds to finance consulting services to help local governments prepare, bid, evaluate, negotiate, and award regional infrastructure PPP projects. It will support the whole range of PPP options from concession, through build-operate-transfer and other forms of investment contracts, to management contracts. Local governments will be required to share the costs of PPP project development in a manner that does not discourage initiatives in this area. The RPDF will only be available to local governments willing to comply with the relevant guidelines to ensure quality transactions that are prepared efficiently and transparently, competitively tendered, and well implemented. Financing proportions will vary according to the phase of project preparation.

Figure A8: Steps Involved in the Preparation and Execution of PPP Project Transactions

Project Identification and Prioritization for Funding under the NPDF and RPDF

Step 1: **Project Identification and Prioritization** (**Line Ministries/Contracting Agencies/Local Governments)**

- Identification and screening of the PPP project
- Public consultations in line with Perpres 67/2005
- Prioritization for preparatory and execution support under the PDF using OGM screening criteria
- Preparation of the proposal request for the support with detailed terms of reference for consultants
- Submission of a funding request to the PDF for the above support

Step 2: **Assessment (PMU)**

- Review of compliance of the proposed PPP project with Perpres. 67/2005
- Assessment of its suitability for PDF funding, using predetermined selection criteria
- Recommendation to the KKPPI Secretariat for NPDF funding, subject to all selection criteria met
- Recommendation to the working group for RPDF projects

Step 3: Oversight/Approval

- NPDF-funded projects will be approved by the deputy chairperson for infrastructure affairs of BAPPENAS, and reported at the next KKPPI ministerial meeting. If a new project that is not in the NPDF pipeline is proposed for funding, then the line minister concerned will present the ministry's request for support at the KKPPI meeting. This will ensure transparency and fairness in project selection.
- RPDF-funded projects will be approved by the director of the PPP Directorate in BAPPENAS, and included in the consolidated reporting to the KKPPI ministerial meeting.

Project Preparation and Transaction Execution

Step 4:
Project Preparation (Line Ministries/Contracting Agencies/Local Governments with PMU Support)

- Recruitment of consultants and transaction advisers (can be combined or separated)
- Monitoring of project preparation
- Quality assurance
- Disbursement of progress payments

Step 5: **Transaction Execution (Line Ministries/Contracting Agencies/Local Governments)**

- With assistance of the PDF-funded transaction advisers, bidding to select private sector partners, and execution of contractual agreements
- Reporting to the KKPPI Secretariat
- Implementation of the PPP project
- Safeguards and statutory monitoring

14. The sector coverage of the RPDF will include (i) water supply, (ii) wastewater treatment and sanitation, (iii) solid waste management and disposal facilities, (iv) passenger transport terminals, (v) markets, (vi) regional government-owned airports and seaports, and (vii) other regional facilities as deemed appropriate by the RPDF steering committee. The RPDF is expected to finance the preparation and transaction execution of more than 40 such regional infrastructure projects. Selection criteria include (i) approval of the PPP project by the head of the regional government; (ii) demonstration of its potential to generate revenue sufficient to recover the capital costs and cover all operating costs; (iii) written commitment from the regional government to comply with applicable national laws, regulations, and policies; competitive and transparent processes; and all relevant environmental and social safeguard standards; (iv) written commitment from the concerned regional government to provide in-kind contribution for project preparation and transaction execution; and (v) submission of satisfactory evidence that the regional government's exposure to debt servicing resulting from the PPP project will be governed by all applicable national Government regulations. If a cost-recovery scheme is designed and successfully implemented, the RPDF may support a larger number of decentralized projects.

2. Technical Advisory Services and Capacity Building

15. This component will provide overall technical advisory services support to the project management unit (PMU) (para. 21) to function effectively in operating the NPDF and RPDF. PMU support will include (i) refinement of selection criteria for providing funding support; (ii) assessment of requests for PDF funding from the line ministries, contracting agencies, and local governments; (iii) technical evaluation of proposals from consultants to be recruited for PPP project preparation and transactions execution; (iv) linking PPP venture proponents with financial institutions capable of funding the proposed projects; (v) based on a review of the PPP procurement process in the first few projects, assessment of the potential institutional and corruption risks involved, and recommendations on strengthening the regulatory framework, including amending Perpres 67/2005 as appropriate, to mitigate such risks; (vi) advisory support to the KKPPI on cross-cutting policy or regulatory measures in the areas of anticorruption, transparency, and dispute resolution that would elicit greater private sector participation; and (vii) overall PPP project promotion.

16. The technical advisory services group will comprise an international PPP expert, who will be recruited to provide full-time support to the PDF for 4 years. International legal expertise will be mobilized to support and advise the PMU on matters relating to PPP contractual arrangements (including management, leasing, and build-operate-transfer contracts; and concession agreements) and transaction execution. The PMU will recruit several national experts to help with national and regional PPP projects, and international experts in the sectors to be funded from the RPDF, such as water supply and sanitation, and small-scale regional infrastructure, to provide support to local governments.

17. Enhancing awareness of PPP projects is vital, particularly as the regulatory framework (Perpres 67/2006) is still relatively new. In particular, private sector participation in decentralized projects needs to be promoted for which most local governments still lack the necessary understanding. Continuous capacity building is also vital, both at the national and decentralized levels. The capacity-building component will develop a training module for PMU staff, covering project appraisal based on feasibility studies and other PPP project documents; and undertake training for stakeholders of regional infrastructure, covering PPP basics and best practice, preparation of feasibility studies, guidelines for tariff setting in full cost-recovery projects, and financing options for PPP project implementation. The capacity-building component will also

support advanced diploma or certificate study programs for government officials for specialized training and education opportunities in areas related to PPP projects.

3. Procurement and Administrative Services

18. The role of this component is to help the PMU exercise its administrative and procurement functions for the PDF. The component will assist the PMU, as well as line ministries, contracting agencies, and local governments, in refining proposal requests (Figure A8, step 4). All procurement-related activities of the PMU will be handled under this component, including support to procurement teams formed under the NPDF and RPDF. In particular, procurement teams for regional projects will receive assistance in the consultant selection process. The support will also include coordinating the quality assurance process; seeking endorsement from line ministries, contracting agencies, and local governments before payments are made to consultants and transactions advisers recruited under the PDF; monitoring and managing disbursements; developing a database and information system to track all steps involved in project management, so that all relevant milestones and deliverables are met; monitoring and evaluating the Project; and managing the project funds.

C. Cost Estimates and Financing Plan

19. **Cost Estimates**. The total cost of the Project is estimated at $38.8 million (Table A8.1). PPP projects under the NPDF will entail a higher unit cost of preparation and transaction execution, given their larger scale. The allocation for RPDF would enable the preparation of a larger number of decentralized PPP projects, which will be less resource intensive on a per-project basis.

20. **Financing Plan.** ADB will provide a loan of $26.5 million from ADB's Special Funds resources. The Government of the Netherlands will provide $7.6 million in grant cofinancing. The Government of Indonesia will allocate staff and other resources in the equivalent of $4.7 million. Table A8.2 presents the financing plan.

Table A8.1: Cost Estimates for Project Development Facility
($ million)

Component and Description	Amount	%
A. PPP Project Preparation and Transaction Execution	21.9	56.4
a. National PPP Projects	10.0	25.8
b. Decentralized Regional PPP Projects	11.9	30.7
B. Technical Advisory Services and Capacity Building	12.0	30.9
C. Procurement and Administrative Services	3.0	7.7
Unallocated	1.1	2.8
Interest and Fees	0.8	2.1
Total	**38.8**	**100.0**

PPP = Public-private partnership
Source: Asian Development Bank estimates.

Table A8.2: Financing Plan
($ million)

Components and Financing Source	Total	%
A. PPP Project Development Facilities		
ADB Loan (Special Funds resources)	16.5	42.5
Government of the Netherlands Grant[a]	3.7	9.6
Government of Indonesia Contribution	2.2	5.7
Subtotal (A)	22.4	57.8
B. PPP Technical Advisory, Capacity Building, Procurement, and Administrative Services		
ADB Loan (Special Funds resources)[b]	10.0	25.8
Government of the Netherlands Grant[a]	3.8	9.9
Government of Indonesia Contribution	2.5	6.5
Subtotal (B)	16.4	42.2
Total	**38.8**	**100**

ADB = Asian Development Bank; PPP = public-private partnership.
[a] The actual contribution of the Government of the Netherlands is $7.56 million.
[b] Includes $1.1 million in unallocated funds.
Source: Asian Development Bank estimates.

C. Implementation and Procurement Arrangements

21. **Implementation Arrangements**. The National Development Planning Agency (BAPPENAS) will be the Executing Agency. The head of the Directorate for Public-Private Partnerships in BAPPENAS will be the overall project director for the PDF on behalf of the Government. The PMU to be established under the directorate will coordinate all three project components. The PMU will be staffed by qualified personnel and host the technical advisers engaged under the second component who will assist in setting up and managing the PDF, training and capacity building of stakeholders, promoting the RPDF with local governments, and formulating a long-term strategy for the PDF. Each participating local government will establish a regional unit, which will be supported by the PMU in managing the RPDF-funded project preparation and transaction execution. A Project Steering Committee (PSC), chaired by BAPPENAS Deputy Chairman for Infrastructure Affairs, will be established to serve as a high-level decision-making and guiding forum for NPDF and RPDF and will comprise senior representatives of CMEA, MOF, Ministry of Home Affairs and the concerned line ministries, and a representative of the associations of regional governments to participate as a resource person.

22. **Sustainability of the PDF**. Given the 5-year horizon of the PDF, ensuring continuity of the technical, procurement, and administrative support provided to the line ministries, contracting agencies, and local governments for project preparation and transaction execution is critical. The Government has agreed that these support functions will be gradually absorbed and continued by the Central PPP Unit currently receiving assistance under two ongoing projects.[6]

[6] ADB. 2005. Technical Assistance to the Republic of Indonesia for Support for Infrastructure Development. Manila (TA 4728-INO for $2 million, to be completed in late 2007), assists the BAPPENAS Secretariat of the KKPPI in a range of areas including finalization and tracking of the Government's own reform program (the Infrastructure Policy Package), formulating the policy framework for public service obligations, initial screening and identification of projects, and preparation of information memorandums for selected projects. The World Bank loan-financed Private Participation in Infrastructure Technical Assistance ($17 million, approved in 2002, to be completed in early 2007) is providing advisory support on legal and regulatory issues to the KKPPI and selected line ministries, and in evaluating and finalizing project proposals.

23. **Procurement Arrangements**. The PMU will coordinate all procurement arrangements, as outlined in para. 91 of the main text and below (Table A8.3). The sample request for proposals will be modified by the concerned line ministries, local governments, or contracting agencies and submitted for review and approval in line with the steps outlined in Figure A8. The beneficiaries of the advanced international studies under the second component will be selected on a competitive basis within the Government.

Table A8.3: Procurement Arrangements

Component	Number of Packages and Indicative Cost Per Package	Procurement Needs and Mode	Implementing Agencies[a]
A. Project Preparation and Transaction Execution	A1. NPDF: 10 packages	• 225 person-months of international consulting services • 413 person-months of national consulting services • International/national firms through QCBS or QBS	• Line ministries or contracting agencies
	A2. RPDF: 40 packages	• 1,855 person-months of national consulting services • International/national firms through QCBS	• Local governments
B. Technical Advisory Services and Capacity Building	B1. Several packages	• 200 person-months of international consulting services • 540 person-months of national consulting services • International/national firms through QCBS; and international/national individual consultants	• BAPPENAS (PMU)
	B2. One package for BPJT legal and financial advisory support	• 36 person-months international consulting services • International individual consultants	• BPJT
	B3. Several packages for P3CU support	• 36 person-months of international consulting services • 84 person-months of national consulting services • International/national firm through QCBS; and international/national individual consultants	• BAPPENAS (P3CU)
	B4. Several packages for PPP strategic campaign	• 100 person-months of national consulting services • National/international firms through CQS	• BAPPENAS (PMU)
	B5. Several packages for PPP study	• 64 person-months of national consulting services • National/international firms through CQS	• BAPPENAS (PMU)
C. Procurement and Administration Services	C1. Several packages	• 55 person-months of international consulting services • 345 person-months of national consulting services • International/national firm through QCBS; and international/national individual consultants	• BAPPENAS (PMU)
D. Procurement of office equipment	D1. Two or three packages	• Computers and other equipment procured through shopping (as part of the consulting services packages)	• BAPPENAS (PMU)

[a] The Project Management Unit at the Executing Agency – the National Development Planning Agency (BAPPENAS) - will coordinate all project activities.

ADB = Asian Development Bank; BAPPENAS = National Development Planning Agency; BPJT = Indonesian Toll Road Authority (Badan Pengawasan Jalan Tol); NPDF = National Component of the Project Development Facility; RPDF = Regional Component of the Project Development Facility; P3CU = Public-Private Partnership Central Unit; PMU = Project Management Unit; QBS = Quality-Based Selection; and QCBS = Quality and Cost-Based Selection.
Source: Asian Development Bank staff.

24. All procurement of goods and services under the Project will be in accordance with ADB's *Procurement Guidelines*. Recruitment of consulting services will be in accordance with ADB's

Guidelines on the Use of Consultants, including the use of simplified technical proposals and quality- and cost-based system for selection of consulting firms.

25. **Anticorruption**. ADB's *Anticorruption Policy* (1998) was explained to and discussed with the Executing Agency. Consistent with its commitment to good governance, accountability and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the Project. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the loan regulations and the bidding documents for the Project. In particular, all contracts financed by ADB in connection with the Project shall include provisions specifying the right of ADB to audit and examine the records and accounts of the Executing Agency and all contractors, suppliers, consultants, and other service providers as they relate to the Project.

26. **Disbursement Arrangements**. To facilitate project implementation, the Government will establish an imprest account to finance eligible small expenditures. The imprest account will be solely for project purposes and will be established at Bank Indonesia (BI). The account will be established, managed, replenished, and liquidated in accordance with ADB's *Loan Disbursement Handbook* (2001) and detailed arrangements agreed between the Government and ADB. The ceiling of the imprest account will be $40,000 and liquidation will be carried out under the statement of expenditures (SOE) procedure for which the limit will be $10,000. ADB will disburse the remainder of the TA loan in accordance with direct payment procedures as described in ADB's *Loan Disbursement Handbook*. The Royal Netherlands Embassy in Indonesia will provide counterpart funds for ADB to administer and these funds will be disbursed as described above.

27. **Accounting, Auditing and Reporting**. The Government will ensure the maintenance of records and accounts to adequately identify goods and services financed from the loan proceeds. The PMU will be responsible for the implementation of the Project including project supervision, monitoring, accounting, and reporting. Based upon BI reports, the PMU will provide ADB with consolidated semiannual reports on project implementation (i.e., progress on commitments and disbursements, preparation status of the PPP projects, problems encountered, and actions taken to remedy the problems, and expected progress during the following half year). The EA will have imprest accounts and related financial statements audited annually by independent auditors whose qualifications, experience, and terms of reference are acceptable to ADB, in accordance with provisions of the Loan Agreement, and as specified in the *Guidelines for the Financial Governance and Management of Investment Projects Financed by the Asian Development Bank*. SOE records will be audited as part of the annual audit. The PMU will submit to ADB certified copies (in English) of such audited accounts and financial statements, and the related reports of the auditors, within 6 months after the close of each financial year. A separate audit opinion on the use of the imprest account and SOE procedures should be included in the annual report. All other reports will be submitted in English according to an agreed timetable. The Project will be consistent with ADB's guidelines on the prevention of fraud and corruption.

28. **Project Performance Monitoring and Evaluation**. To ensure that PPP projects are prepared effectively and that their benefits are maximized, a project performance monitoring system (PPMS) will be developed in accordance with ADB's *Project Performance Management System (PPMS) Handbook* and project objectives. The PPMS will assist the PMU in monitoring facility inputs, progress in assistance, outcomes, and impacts. Indicators of capacity building and information dissemination for government agencies, financial institutions, potential investors, and other stakeholders will be incorporated in the design of the system to facilitate the monitoring and evaluation of project benefits. Data collection for the PPMS will be undertaken by the PMU and regional governments.

29. **Project Review**. ADB and the Government will jointly undertake annual reviews of the Project to assess progress and identify constraints and ways to address identified constraints. Such reviews will commence 6 months following loan effectiveness to enable the Executing Agency to make adjustments in the project design and implementation arrangements as needed. The review will cover the (i) status of PPP project preparation and transaction execution; (ii) performance of the consultants under the three project components; and (iii) possible changes in project scope, implementation arrangements and allocation of loan proceeds. A midterm review will be conducted within 3 years of loan effectiveness.

D. Environmental and Social Measures

30. The PDF will not finance any investments in project implementation, as it will support only the preparation of pre- or full feasibility studies and PPP procurement up to the signing of the concession agreement (or other contractual arrangements). Requests for any subsequent ADB financing for project investments will be dealt with separately, and will be subject to all of ADB's requirements, particularly with regard to environmental and social safeguards. As ADB financing is not assumed at the project preparation stage, the PDF will not be able to enforce ADB's detailed safeguard policies. However, the principles of these policies are reflected in the Government's existing procedures. Environmental and social impact assessment, including issues of involuntary resettlement and indigenous peoples, will be integral components in the preparation of PPP projects to be supported by the PDF. For projects funded from the PDF, environmental assessments will be undertaken and review procedures developed in compliance with the Government's own existing regulations, and in broad accordance with principles and objectives specified in ADB's Environmental Policy and Operations Manual Section F1: Environmental Considerations in ADB Operations. Social safeguard (involuntary resettlement and indigenous peoples) assessments will be also be undertaken in accordance with the current government regulations. In the event that ADB financing is sought for project implementation, additional assessments may have to be carried out in line with the principles and objectives of ADB's policies on involuntary resettlement and indigenous peoples as outlined in *Handbook on Poverty and Social Analysis,* and *Handbook on Resettlement: A Guide to Good Practice*. As the program loan component of the Infrastructure Reform Sector Development Program aims to reduce the gaps between the Government's and ADB's requirements, it is envisaged that there will be convergence in the scope of the feasibility studies in these areas over the duration of the PDF.

Table A8.4: Legal and Regulatory Requirements and Criteria for PPP Projects

No.	REQUIREMENT/CRITERION	Compliance		
		Full	Partial	None
	A. Perpres 67/2005:			
1.	Conformity with the national/regional medium-term development plan			
2.	Conformity with the sector master plan			
3.	Analysis of interconnection among sectors and regions			
4.	Analysis of costs and social benefits			
5.	Public consultations			
6.	Pre-feasibility study			
7.	Cooperation plan with the private sector			
8.	Project financing plan, including sources of funds			
9.	Plan for the selection of private sector partners, including schedule, procedure, and evaluation method			
	B. CMEA Regulations 3 and 4/2006:			
1.	Compliance with the relevant laws and regulations			
2.	Conformity with the RPJM			
3.	Conformity with the regional spatial plan			
4.	Conformity with the sector's strategic plan (blueprint)			
5.	Technical and financial viability of the project (pre-feasibility study)			
6.	Attractiveness of the project as to ensure competition			
7.	Suitability of the project for PPP			
8.	Proposed form of PPP			
9.	Availability of land or a detailed land acquisition plan			
10.	Availability of an environmental impact analysis			
11.	Availability of bidding documents (including draft PPP contract)			
12.	Availability of a socio-economic cost-benefit analysis			
13.	Availability of a risk analysis (including risk allocation, quantification and mitigation)			
14.	Clarity on the type and amount of the requested government support			
15.	Record of public consultations			
	C. MOF Regulation 38/2006:			
1.	Conformity with applicable laws and regulations (legality norm)			
2.	Technical and financial feasibility (project quality)			
3.	Capacity of the government budget to provide the needed support (fiscal sustainability)			
4.	Transparency principle			

CMEA = Coordinating Ministry of Economic Affairs; MOF = Ministry of Finance; Perpres = Presidential Regulation; PPP = public-private partnership; and RPJM = Medium-Term Development Plan

Source: Asian Development Bank staff.

TECHNICAL ASSISTANCE FOR ENHANCING PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE PROVISION

A. Introduction

1. The Ministry of Finance (MOF) and the Committee on Policy for the Acceleration of Infrastructure Development (KKPPI) asked the Asian Development Bank (ADB) for technical assistance (TA) to increase private sector participation in the provision of infrastructure. The TA will support MOF in determining and providing risk-sharing support to private investors in infrastructure projects, and designing and establishing infrastructure financing mechanisms. For the KKPPI, which has overall responsibility for coordinating the preparation, bidding, and contracting of public-private partnership (PPP) projects, the TA will provide support in effective communications on and social marketing of infrastructure reforms. The TA has four components.

B. Scope

1. Risk Management

2. Fiscal prudence has been the Government's overarching principle and foundation for macroeconomic management since the Asian financial crisis. While this prudence has served Indonesia well by reducing public debt from more than 100% of gross domestic product (GDP) to about 45% in 2005 and containing fiscal deficit from more than 2.5% of GDP in the early 2000s to 0.5%, it did impede development spending. Bearing in mind the adverse outcomes of the precrisis practice of open-ended assurances through "comfort letters" to well-connected private investors, the fiscal prudence has also translated into a very cautious stance by the Government with regard to any fiscal support to the private sector, particularly in large and risky projects with revenue flows spread over a long period. With macroeconomic stability regained, the Government is taking a more proactive stance with an increasing realization that investors will not come unless some form of assurance is given by the public sector. To attract badly needed private sector investments in infrastructure, MOF issued Decree 38/2006 on Risk Mitigation and Management in Infrastructure Provision that sets out the criteria for determining the Government's fiscal support, both cash and noncash.

3. The various forms of risk-sharing support that the Government could provide include coinvestments in PPP projects to meet their upfront needs (e.g., for land acquisition); fiscal incentives such as tax-holidays or tax exemptions; subsidies; and event-dependent guarantees. MOF needs help in assessing the type and level of risk-sharing support required to accelerate infrastructure provision.

4. The goal of this component is to help enhance the capacity of the Risk Management Unit (RMU) in MOF through on-the-job training and analysis of risk-sharing support for specific PPP infrastructure transactions. The tasks include the following:

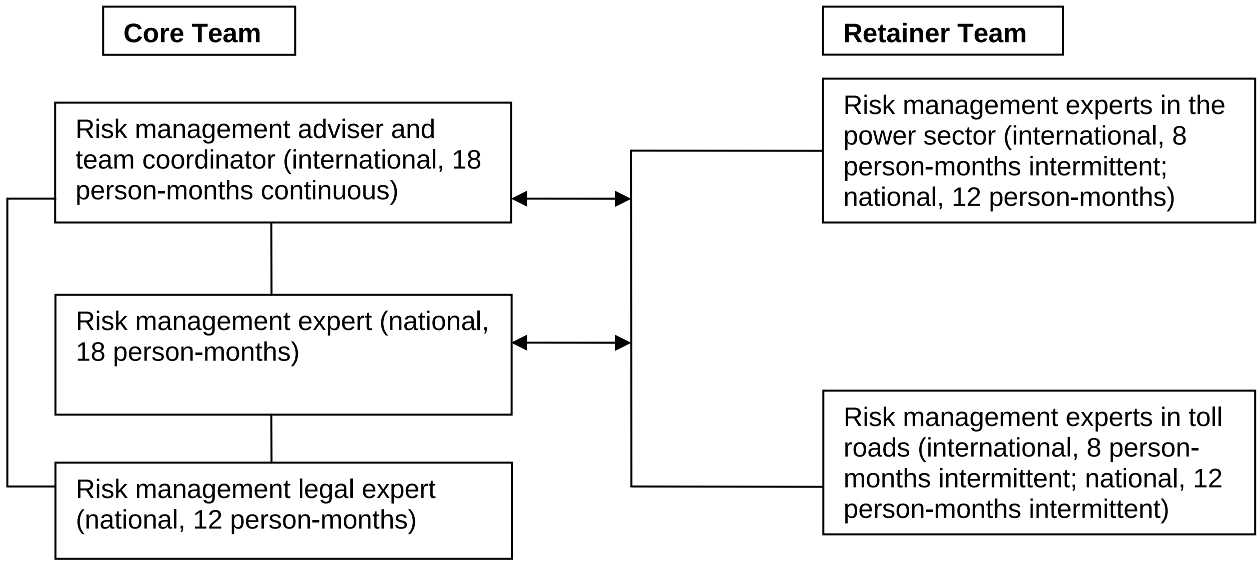
(i) Determine the type of government support that should be provided at sector and project levels.
(ii) Establish, from a prudent macroeconomic management point of view, overall caps on the risk-sharing support that the Government can provide.
(iii) Evaluate specific project proposals for risk-sharing support that are passed on by the KKPPI to MOF, decide whether or not to provide such support; and determine the caps on its direct and contingent portions.

(iv) Liaise with the transactions advisers appointed by line ministries and contracting agencies to learn the financial structure and technical details of the projects in the pipeline that are likely to be submitted to the RMU.
(v) Advise the KKPPI to ensure that the Government's support is the least possible but realistic enough to attract investments.
(vi) Based on quantitative and qualitative analyses (including evaluations of sector policies and priorities; demand for services being provided; structure of the proposed transaction, etc.), recommend the type and size of the fiscal support for each transaction.
(vii) Evaluate the risk-sharing arrangements between national, provincial, and district governments, and help MOF allocate optimal sharing of overall obligations for high-priority projects.
(viii) Advise on the establishment and structure of a guarantee fund, and formulate the standard operating procedures anchored on fiscal prudence and good governance.
(ix) Estimate the annual budgetary allocations required to meet the promised fiscal support, and the potential drawdown from the guarantee fund.
(x) Monitor and assess the overall financial obligations created by the Government's decisions.
(xi) Support MOF and KKPPI in justifying MOF's decisions, exposure caused, and outcomes to other stakeholders including Parliament, and develop an effective strategy for such interfaces.
(xii) Advise relevant MOF officials on reporting the risk-sharing support provided in line with government accounting standards.
(xiii) Based on these activities, advise MOF on reformulating the risk management and overall debt management strategy, whenever necessary.

5. **Expertise Needed and Duration of Advisory Support**. This TA component has to be implemented in a flexible manner, given that the need for advisory support will be contingent on the pace at which project transactions are submitted to MOF. Figure A9 illustrates the expertise needed and the indicative duration of support. Implementation will be divided into two phases.

(i) **Phase 1 (3 months)**. The experts will establish contact with officials in MOF and KKPPI; formulate a detailed work plan; agree with MOF officials on their functions and responsibilities; begin to build up basic capacity in the RMU team based on the initial transactions that the team will evaluate; and demonstrate how in-depth assessments are made and decisions reached through actual project transactions. The experts will discuss the needs for their field presence in phase 2 and work out a clear plan for continuous remote access and interface with the relevant MOF and other ministry officials during their absence.
(ii) **Phase 2 (15 months)**. This phase will be implemented in a flexible manner with regard to the retainer experts, to give time for projects to be prepared, considered by the KKPPI, and submitted to the RMU for risk-sharing support. The experts may spend part of this phase in Indonesia, while the remaining part will be spent on a retainer basis at their home offices or through visits to Indonesia as needed, so that they can provide continuous support to government officials.

Figure A9: Expertise to Be Provided Under the First Component to the Risk Management Unit of the Ministry of Finance



2. Establishment of a Sound Fiduciary Framework for Fund Management

6. The Government is contemplating establishing various funding mechanisms to support PPP projects, including an Indonesia infrastructure fund, a guarantee fund, and a revolving fund for land acquisition. While the institutional mechanisms for these funds are being formulated, the Directorate General of Treasury in MOF is expected to oversee their establishment and monitoring from a fiduciary point of view. This TA component will support MOF in designing and establishing a sound fund management structure. An international funds management adviser and a national funds management expert will be recruited on an individual basis for about 10 person-months each. Their tasks will include the following:

(i) Advise the Directorate General of Treasury on the optimal management structures, consistent with Indonesian regulations and international best practices, for the various funds.
(ii) Design the necessary monitoring, operation, and financial reporting systems within MOF for the various funds.
(iii) Formulate, in consultation with the line agencies responsible for conceptualizing or establishing the funds, the standard operating procedures for interfacing with MOF.
(iv) Prepare an operations manual for the various funds for use in MOF and other agencies concerned.

3. Reform Communication and Social Marketing

7. The Infrastructure Reform Sector Development Program covers nine sectors, spanning the jurisdiction of close to 20 line ministries, agencies and regulatory bodies, and a large number of state-owned enterprises, and consists of many actions and outputs. Given the complexity and

political sensitivity of reforms, for instance in regulatory arrangements or cost recovery, their rationale must be clearly communicated both within and outside the Government. Without this, the risk is considerable that the reforms may not be understood well by the general public, or even the concerned government officials. An international communications/social marketing expert engaged for 4 person-months will support the Coordinating Ministry of Economic Affairs (CMEA), which acts as the KKPPI Secretariat, in designing a communication strategy. He/she will be assisted by a national expert engaged for 10 person-months. Tasks will include the following:

(i) Help the KKPPI identify sensitive reform initiatives that need to be effectively communicated to stakeholders, both within and outside the Government.
(ii) Design communication strategies that can be modified and replicated for different types of reforms and stakeholders, integrating lessons from other countries and good communication practices adopted elsewhere.
(iii) Advise the KKPPI if such communication has not worked in other countries and, if so, explore with the concerned line ministries/agencies (through the KKPPI) what changes if any can be made in modifying the presentational aspects or timing of the reform initiatives.
(iv) Design communication materials for at least two important and sensitive reform areas, and disseminate them through effective channels.

4. Support for Preliminary Technical Preparations under the Project Development Facilities

8. The project loan will help accelerate PSP in infrastructure sectors by supporting the establishment of an infrastructure project development facility (PDF). The PDF will alleviate one of the most critical constraints impeding infrastructure development, namely, the lack of adequate project preparation. This TA component will help finalize technical preparations for the PDF so as to ensure quality at entrance and readiness of the PDF to work effectively. An international project management specialist and a national procurement specialist engaged for 5 months will support the Directorate for Public-Private Partnerships in BAPPENAS, which acts as the overall project directorate for the PDF on behalf of the Government, in preparing start up documentation for each project proposal. Their tasks will include the following:

(i) Help the Directorate conduct demand surveys for selected projects, and collect baseline data for these;
(ii) Prepare standard (pre-)feasibility study, bidding and contract documentation for the PDF;
(iii) Develop public campaign kits and conduct public information and communication activities and workshops;
(iv) Consult with national and local governments on the suggested implementation arrangements for the PDF and finalize detailed arrangements thereafter; and
(v) Prepare the project organizational setup in BAPPENAS.

C. Implementation and Reporting Arrangements

9. **Implementation**. The executing agencies will be

(i) the RMU under the newly established Fiscal Policy Office in MOF for the risk management component;
(ii) Directorate General for Treasury in MOF for the funds management component;

(iii) CMEA represented by the deputy for infrastructure for the reform communication and social marketing component; and
(iv) Directorate for Public-Private Partnerships in BAPPENAS for quality at entrance of the PDF.

10. **Recruitment**. All consultants will be recruited in accordance with ADB's *Guidelines on the Use of Consultants*. Given the complexity of risk management and since the extent of the advisory services will depend on the emerging pipeline of infrastructure projects, the implementation arrangements for the first component will be kept flexible. If a firm can provide the retainer type of services in a flexible manner without increasing the cost significantly, then a firm will be recruited. Otherwise, the core team will be recruited initially on an individual basis, and the team coordinator will be responsible for recruiting the retainer team and formulating a work plan to utilize their services depending on the risk assessment needs for specific projects. Further, as such needs may evolve and change during TA implementation, the allocation of person-months for the first component is indicative only. If the Government and ADB feel that consultants should initially be recruited for a shorter duration to meet specific needs, with resources reserved for future emerging needs, such an approach will be adopted. The consultants under the second and third components will be recruited on an individual basis.

11. **Reporting Arrangements**. The team leaders for the respective components will coordinate the reporting arrangements. Inception, mid-contract, and final reports will be prepared for all components. Emphasis will be on technical content rather than administrative aspects, describing the advice provided to the Government in simple terms. Operational guidelines or manuals should be comprehensive and final versions should be prepared with stakeholder inputs. In addition, technical briefs will be prepared by consultants on a needs basis.

D. Cost Estimates

12. Table A9 presents an indicative allocation of the TA resources across the four components. The total cost of the TA is estimated at $2,500,000. The Government has asked ADB to finance $2,000,000 on a grant basis, with the rest to be provided in the form of counterpart support by the concerned executing agencies. Most of this support is expected to be in the form of government staff inputs, which are already factored into the regular work plans.

Table A9: Cost Estimates for Technical Assistance for Enhancing Infrastructure Provision

Item	Unit	Unit Cost	Total Cost
		($ '000)	
A. Asian Development Bank Financing			
1. Consulting Services			**1,633.0**
a. Risk Management Component			
International Consultants	34	27.0	918.0
National Experts	54	6.0	324.0
b. Fund Management Component			
International Consultant	4	22.0	88.0
National Experts	10	5.0	50.0
c. Reform Communication-Social Marketing			
International Consultants	4	22.0	88.0
National Experts	10	5.0	50.0
d. Quality at Entrance of PDF			
International Consultant	5	18.0	90.0
National Expert	5	5.0	25.0
2. Workshops	3	20.0	60.0
3. Surveys and Data Collection	3	10.0	30.0
4. Equipment and Communications			62.5
Computers	7	2.0	14.0
Printers	4	1.3	5.0
Photocopiers (Rental)	2	1.3	2.5
Monthly Communications/Reporting	25	1.5	37.5
Office Utilities and Maintenance	5	0.7	3.5
Subtotal (1+2+3+4)			**1,785.5**
5. Contingency			**214.5**
Subtotal (A)			**2,000.0**
B. Government Counterpart Support			500.0
1. Staff Services	120	3.0	360.0
2. Office Space	4	15.0	60.0
3. Logistics—Workshops and Other	4	20.0	80.0
Total			**2,500.0**

Note: Unit is person-months for consultants; and number of physical units for others.
Source: Asian Development Bank estimates and Government of Indonesia officials.

SUMMARY POVERTY REDUCTION AND SOCIAL ANALYSIS

A. Linkages to the Country Poverty Analysis

Is the sector identified as a national priority in country poverty analysis?	X Yes ☐ No	**Is the sector identified as a national priority in country poverty partnership agreement?**	X Yes ☐ No

Contribution of the sector or subsector to reduce poverty in Indonesia:

Infrastructure development and economic growth are strongly linked. Greater provision of infrastructure and related services has a particularly beneficial impact on the poor by, for instance, improving access to markets and areas with greater economic and employment opportunities. For the poor, in particular, improved water supply and sanitation; rural electrification; and better community and subdistrict infrastructure can have tremendous beneficial impacts.

Indonesia's poor investment climate and major deficiencies in infrastructure provision have been identified as key constraints to growth. Infrastructure progress has virtually been at stand-still since the 1997 Asian financial crisis. Due to lack of adequate investment for maintenance, the quality of existing infrastructure has worsened. In particular, the deterioration of water supply and sanitation infrastructure and transport networks (roads, railways and sea transport) has led to a lower quality of life for the poor. For instance, a large majority of the population (an estimated 210 million) living outside of urban areas does not have access to sewerage systems.

The constraints that affect growth and impede poverty reduction are characterized by

- poor service coverage outside of Java, in general in all infrastructure sectors; where some services are available, the quality is low, disjointed, and unreliable;
- regional disparities in the availability of public sector resources and weaknesses in legal and institutional frameworks curtailing investment; and
- failure to meet public service obligations (PSOs) by many state-owned enterprises (SOEs), and lack of a consistent approach across the sectors in this regard.

Any tariff adjustment would inevitably have an impact on the poor. Nonetheless, tariffs must be in line with cost-recovery principles to ensure adequate quantity and quality of infrastructure services. In one major area, namely oil prices, the Government recently reduced subsidies, as these subsidies never benefited the poor (given that the middle class consumed the most). Given the large and direct impact through the general rise in inflation following the increase in oil prices in 2005, the Government designed and implemented a credible compensation program. A medium-term expenditure program, with efficient public expenditure reorientation, is being designed. The 2006 budget already reflects large reallocations to pro-poor programs.

Another major constraint entails land acquisition for infrastructure projects. The Presidential Regulation (Perpres) 36/2005, as amended through Perpres 65/2006, provides a good framework for land acquisition. Implementing regulations are being drafted, aimed to bring the Indonesian legal requirements on livelihood restoration, consultation, grievance redressal, and rights of squatters in alignment with those of the Asian Development Bank (ADB). For the financing for land acquisition, particularly for toll-road projects, the need for the Government to provide public investment support, given the cost as well as implementation difficulties in acquiring land, is becoming clearer. A balanced regulatory framework is critical to guide such public investments and safeguard the interests of those likely to be affected.

The Infrastructure Reform Sector Development Program (IRSDP) adopts a comprehensive approach to deal with all of these issues over the medium-term. Given the complexity of reforms, a program cluster framework is adopted to support infrastructure development in a phased manner. The primary objective of the IRSDP is to improve the investment climate, and thereby boost economic growth and reduce poverty.

Overall, IRSDP implementation will have a net beneficial impact on poverty reduction. Besides addressing the immediate quality of life concerns (through, for instance, leveraging improved provision of water supply and sanitation services), the IRSDP will enhance access and employment opportunities for the poor by 2010. Decentralized infrastructure projects, particularly the model PPPs to be pursued under subcomponents 2 and 3, will help in direct job creation. The proposed project development facility will have a direct positive impact by designing such projects.

In parallel with the IRSDP, the Government is implementing the Rural Infrastructure Strengthening Program (also supported by ADB through the Rural Infrastructure Support Project, approved in December 2005), which gives special attention to infrastructure needs in poorer and disadvantaged regions of Indonesia.

B. Poverty Analysis **Targeting Classification:** General intervention

What type of poverty analysis is needed?
The IRSDP directly supports implementation of the Government's programs on poverty reduction. In particular, the measures in the IRSDP have close linkages with (i) the National Poverty Reduction Strategy (NPRS); (ii) the Poverty Partnership Agreement between the Government ADB, and elements of the NPRS supported under the agreement; and (iii) the Government's medium-term development plan (RPJM) with its clear poverty reduction targets of halving poverty from 16.6% in 2004 to 8.2% in 2009.

Some noteworthy features of the linkages between the IRSDP actions and the NPRS include the following:

- The IRSDP focuses on enhancing private sector participation in NPRS implementation through broad-ranging measures, by strengthening the overall investment climate, and other supplementary reforms that are undertaken in coordination with projects supported by ADB and other development partners.
- Measures for mobilizing public and private sector resources for immediate and long-term infrastructure development will have significant effects on poverty reduction.
- The focus on risk-sharing to encourage private sector participation will help meet the demand for infrastructure needed to provide basic services and attract productive investments to generate employment.

Indicative links between IRSDP actions and the NPRS are shown in the following table.

Links between the National Poverty Reduction Strategy and the Infrastructure Reform Program

National Poverty Reduction Strategy	Infrastructure Reform Program Policy Actions
Macroeconomic Stability	
Prudent fiscal management	• Reduce subsidies to non-poor, and evaluate administered prices. • Attract PSP in infrastructure development in commercially viable sectors, and conserve public sector resources for increasing health and education spending.
Basic Rights Basic services such as health, education, and water supply; access to decent work; and reduction of regional inequalities	• Provide direct support for water supply and sanitation projects. • Conserve public sector resources for essential social sector needs. • Adopt an overall framework for public service obligations (PSOs), leading to harmonized treatment and provisions for PSOs across all infrastructure sectors. • Develop a clear legal framework in each infrastructure sector governing PSOs.
Poverty Partnership Implementation Mechanism	
Private sector to play a role in investment, production, and distribution of goods and services; generate taxes; create jobs and infrastructure; and provide access to assets and technology	• Provide foremost emphasis on designing and strengthening public-private partnerships in all infrastructure sectors.

C. Participatory Process

Is there a stakeholder analysis? ☐ Yes X No
Note: The IRSDP is anchored on the Government's comprehensive Infrastructure Policy Package. In formulating this package, the Government undertook several rounds of consultations with a broad-range of stakeholders. ADB participated in these consultations. Some key elements of the policy package with a possible direct impact on the poor (e.g., implementing mechanisms for land acquisition) will be discussed before being finalized.

Is there a participation strategy? ☐ Yes X No

D. Gender Development

<table>
<tr><td colspan="4">Strategy to maximize impacts on women:

By improving access to better water supply and sanitation facilities, the IRSDP will help alleviate some key constraints that affect women’s participation in the labor market.

Has an output been prepared? ☐ Yes x No</td></tr>
<tr><td colspan="4">E. Social Safeguards and Other Social Risks</td></tr>
<tr><th>Item</th><th>Significant/ Not Significant/ None</th><th>Strategy to Address Issues</th><th>Plan Required</th></tr>
<tr><td>Resettlement</td><td>☐ Significant

X None</td><td>The IRSDP will not provide investment support to any infrastructure projects. Support provided under the IRSDP to improve the legal framework for land acquisition for public infrastructure will result in government land acquisition practices conforming more closely to the requirement of ADB’s involuntary resettlement policy.</td><td>☐ Full

☐ Short

X None</td></tr>
<tr><td>Affordability</td><td>x Significant

☐Not significant

☐ None</td><td>The IRSDP supports a general review of tariff policies in all infrastructure sectors. In one key area—oil—the Government has already started moving away from the administered price mechanism. It has put in place an adequate compensation program to cushion the immediate adverse impact of price increases on the poor. This will be supplemented by effective public expenditure reorientation in the medium term. The adoption of sound approaches to meet the PSOs will mitigate any adverse effects of tariff adjustments. Moving forward, the Government also needs to address electricity tariff adjustments, as inability to recover costs greatly affects the State Electricity Corporation’s financial viability. The Government’s vision is to adopt a progressive system that protects the poor in the event upward adjustments are made on tariffs.</td><td>☐ Yes

X No</td></tr>
<tr><td>Labor</td><td>☐ Significant

X Not significant (Positive impact)

☐ None</td><td>The impact on labor is positive through improvement in the investment climate. The IRSDP promotes investments in one of the most productive areas, namely infrastructure development. The policy and legal measures, as well as the public and private sector transactions that will be supported in general through the IRSDP, will create jobs necessary to absorb the increasing number of unemployed.</td><td>☐ Yes

x No</td></tr>
<tr><td>Indigenous Peoples</td><td>☐ Significant

X Not significant
☐ None</td><td>Improvement of the legal framework will facilitate land acquisition for public infrastructure. Perpres 36/2005 and Perpres 65/200 recognize traditional communal lands or usufruct rights. The implementing regulations currently being drafted to these presidential regulations are expected to help bring Indonesian legal requirements close to ADB’s requirements on the rights of indigenous people.</td><td>☐ Yes

X No</td></tr>
<tr><td>Other Risks and/or Vulnerabilities</td><td>X Significant

☐ Not significant

☐ None</td><td>External factors (increasing terrorist acts or pandemic) or political disturbances could result in incomplete implementation of the policies or delay in achieving anticipated benefits of the IRSDP. The Government has focused its attention on consensus building for sensitive reforms (e.g., tariff policies; land acquisition). Risks stemming from policy or regulatory reversals are recognized, and the KKPPI is empowered to coordinate and balance between the investors’ and Indonesia’s national interests.</td><td>☐ Yes

x No</td></tr>
</table>