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**USAID/INDONESIA**

**FINANCING AND COMMERCIALIZING THE PRIVATE PROVISION OF PUBLIC SERVICES**

FINAL REPORT

MARCH 25, 1991

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006

Telephone 202 296 0800

Price Waterhouse

March 25, 1991

Messrs. James Watson and Joseph Carroll
Office of Private Sector Development
USAID/Indonesia
Jakarta, Indonesia

Gentlemen:

Re: APRE/EM - Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Indonesia - Financial Markets Project (FMP)

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Attached please find our Final Report on Financing and Commercializing the Private Provision of Public Services as prepared by Price Waterhouse, Prime Contractor under FSDP.

On behalf of Bill Hollinger and the Project team, I would like to thank you for your guidance and support in preparing this report.

We greatly appreciate the opportunity to be of service to both the Government of Indonesia and USAID/Indonesia on this interesting and very important assignment, and look forward to the possibility of working with you again in the future.

Sincerely,

Mark Camstra

Mark Camstra
Senior Manager
International Consulting Services

Attachment (as stated)

cc: J. Richard Breen, FSDP Project Director, PW
Sandra Frydman, FSDP Project Officer, APRE/EM

# TABLE OF CONTENTS

PAGE

LIST OF ATTACHMENTS:

ATTACHMENT 1: THE PRIVATE PROVISION OF PUBLIC SERVICES: A SUGGESTED NEGOTIATING FRAMEWORK

ATTACMENT 2: SUGGESTED PRIVATE POWER IMPLEMENTATION STRUCTURE

ATTACHMENT 3: BOT PROJECT STRUCTURE

ATTACHMENT 4: INDEPENDENT POWER PRODUCER CONTRACT STRUCTURE

ATTACHMENT 5: SUGGESTED CHANGES TO GOVERNMENT-ISSUED TERMS OF REFERENCE IN THE PRIVATE POWER SECTOR

# I. EXECUTIVE SUMMARY

## A. Introduction

A proper balance between the actual provison of public services and the overall level of economic activity is essential to permit continued economic growth in Indonesia. The response of the Indonesian economy to the series of reform packages and restructuring measures adopted by the Government has been vigorous. Current and prospective levels of growth will require increased infrastructure capacity at a faster rate than previously envisioned. This in turn will require levels of investment that are very likely to tax the Government's capacity to finance all public sector facilities, along with all other claims on the Government's revenues.

For this reason, the Government is considering a role for private investment in the provision of public, or infrastructure services. The scope for private participation is most likely to be greatest in electric power, transport (including toll roads, harbors, and airports), telecommunications, and urban services such as water treatment and supply and waste disposal, although opportunities may arise in other public services areas.

Several proposals to implement such projects have already been put forward by private sponsors. The evaluation of these proposals, the solicitation of other proposals, the selection or rejection of individual proposals, and the effective implementation of selected projects will require a sound policy framework. That framework should, as unambiguously as possible, specify the Government's objectives. On the basis of those objectives, the framework would then define the appropriate role for private participation and specify negotiating parameters to guide discussions with project sponsors.

## B. Objective

The objective of this report is to suggest a basic policy framework designed to underpin the efforts of the Government of Indonesia (GOI) in implementing a program to provide public services by means of private sector investment. The elements of this policy framework are intended to determine the evaluation criteria to select privately-financed and -operated projects, and provide the basis for establishing guidelines and parameters for Government officials to use in negotiating proposals with private sponsors. The scope of this report includes:

- o Specify the economic rationale and consequences to support a significant departure in policy on the part of the GOI

- Define suggested evaluation criteria for use by the Government in evaluating proposals for private investment in the provision of public services

- Identify key negotiating parameters which typically must be addressed in conducting negotiations with private sponsors.

This report was prepared by William Hollinger and Mark Camstra, of Price Waterhouse, under the auspices of USAID/Indonesia's Financial Markets Project (FMP) and APRE/EM's Financial Sector Development Project (FSDP). The team drew on technical support from Price Waterhouse's International and Utilities Practice Units, based in Washington, D.C.

## C. Benefits of the Private Provision of Public Services

An expanded role for the private sector in the provision of public services and infrastructure facilities potentially has a number of fundamental benefits for Indonesia's national development: reduced financial burden of claims on the national budget, expanded capacity to provide public services, and greater efficiency in the allocation of resources.

On the basis of financial and efficiency criteria, indications are that the economy stands to benefit substantially by providing public services through private sector investment. From a financial point of view, the gap between the projected, derived demand for infrastructure services and the financial capacity of the public sector to meet that level of demand is significant, and constitutes one of the key rationale for the Government to pursue a private provision program. In the power sector alone investments of not less than an estimated US$3 billion per year are required to sustain current growth. In the telecommunications sector, which is much more diverse than the power sector, the financial gap is even more significant, also measuring in the billions of dollars.

From an efficiency point of view, indications are that economic growth could also benefit significantly should the Government be able to organize and implement a program to provide public services through private investment. This is because the Government's ability to provide additional capacity for public services is not limited solely by financial constraints; the appropriately skilled human resources and the management capacity that the Government can mobilize to support an expansion of public services are limited. Moreover, the operating modalities in private enterprise may generate more effective incentives to keep costs down and to be responsive to shifting patterns of demand. By increasing the number of participants in a market, competition is increased, which tends to restrain costs and prices.

Hence, the fundamental rationale for the Government to pursue private investment projects in providing public services include:

- Leads to an expanded capacity for the provision of public services: To the extent that there is real net addition to the financial resources committed by private sponsors, there will be a lower claim on the national budget for any given level of public services. To ensure such additionality, the Government must consider a number of issues in evaluating individual proposals, e.g., degree of recourse, the net impact on tax receipts of the proposed terms, any element of "crowding out" that the proposed financing might cause.

- Leads to increased efficiency in the allocation of scarce resources: Increased efficiency in the provision of public services will arise to the extent that the private sector can provide a mix of more or better management, better technology, better services (especially greater options open to consumers), and greater competition.

## D. Potential Costs and Limits

There are a number of potential costs and limits that the Government must take into account in designing a private provision program in general, and in developing negotiating parameters designed to minimize these potential costs:

- Increased financial exposure: Within the broader limits to which an economy can support a corpus of debt, additional finance for expanded growth in capacity constitutes an increased claim on the debt servicing capacity of the economy. The amount and potential impact of increased foreign exchange exposure and domestic debt finance must be carefully considered within the broader economic policy context, and can be controlled by minimizing the amount of recourse to the Government in the financing arrangements negotiated with private sponsors.

- Increased inflationary pressures: Expanded infrastructure investment based on financing that is additional to that otherwise available will generate additional pressures on prices and on the supply of real resources. This is not a reason to reject private participation, as the latter reduces bottlenecks which also create inflationary pressures and constrain growth. The objective is to balance the propensities of private participation to both generate and reduce inflation in such a way that the full benefits of private participation can be borne by the economy.

- <u>Increased coordination requirements</u>: Introducing private participation into activities that were previously the province solely of the Government creates a number of interfaces, and hence new coordination requirements, that did not previously exist. This can be managed in the process of establishing efficient institutional arrangements within the Government, and putting in place appropriate guidelines and procedures to identify, evaluate and implement projects.

- <u>Assuring security of supply</u>: The fact that the GOI, acting through designated public entities such as PLN or Perumtel, has the constitutional and political responsibility for adequacy and reliability of supply for key public services, must be balanced against the reality that private parties can also fail to perform. This risk is minimized through the project identification and proposal evaluation process, and by negotiating implementation agreements which establish a reasonable timetable and framework for implementing projects.

Importantly, these costs and limits are controllable and can be minimized by the Government in the process of defining a coherent set of policies, and selecting and negotiating projects within the context of these policies. To the extent that the Government can clearly define and implement its polices, and thereby minimize the costs of implementing private participation, the benefits associated with such programs could readily outweigh the costs.

## E. <u>Selection Criteria</u>

In line with the benefits associated with the private provision of a public service, balanced with the costs, a proposal should be favorably considered by the Government if it meets a number of selection criteria, including:

- Serves a clearly defined need as established within the context of the Government's overall private provision program

- Breaks a constraining bottleneck, or avoids one from arising, in the economy's growth

- Provides capacity and services that could not otherwise have been provided, or could not have been provided more economically by the public sector

- o Provides financing additional to what the Government could otherwise have mobilized which does not lead to either an excessive foreign exchange exposure for the economy or complicates the Government's own dealings in the international capital markets.

- o Enhances or expands the management capability available to the Government, provide access to better technology, permit a better spread of risks among the parties in the economy, or some combination of these elements.

Applying these criteria will assure to the maximum extent possible that a desirable private sector project provides important additionality to the economy, and that it does not just substitute for an equally available and effective public sector project.

### F. Basic Negotiating Guidelines and Parameters

The negotiating parameters set out below for the financial, economic, commercial and other aspects of a project are designed to assure that the projects selected on the basis of the Government's evaluation criteria are implemented in such a way that they increase the efficiency of the total system, and ensure that services are provided at a cost equal to or less than those services that would otherwise be available to the economy.

The Government should develop negotiating strategies with the following guidelines in mind:

- o Recourse: Minimize recourse to the Government with respect to the financial obligations of the project, and in particular avoid the acceptance of any construction or operating risk.

- o Foreign exchange risk: Minimize the Government's assumption of exchange risk to that proportion of sales proceeds necessary to service foreign borrowings and the foreign exchange costs of operations.

- o Price: Establish a benchmark ceiling price defined in terms of the true economic avoided cost of providing the service with contracted prices to be equal to or less than that benchmark.

- o Market-driven pricing: Establish pricing mechanisms that are driven by market forces to the maximum extent possible, and that avoid or minimize subsidies.

- *Competition*: Achieve as much competition as possible consistent with social and political objectives. Maximizing competition would mean favoring Build-Own-Operate (BOO) over Build-Own-Transfer (BOT) arrangements whenever possible or feasible.

- *Security of supply*: Balance the investor's need for secured sales revenues ("take-or-pay" provisions, or their equivalent) with security of supply or performance assurances.

- *Equity participation*: Maximize the equity participation on the part of the project sponsors. The Government should avoid taking any type of equity position in privately-sponsored public services projects.

- *Guarantees*: Avoid guarantees on profits or rates of return. It is up to the sponsor to convert his reasonable expectations of earning a desired rate of return without assurances or guarantees from the Government.

- *Incentives*: Limit incentives to those of general applicability to investment projects to the maximum extent possible.

- *Training and technology transfer*: Require training programs and a process of technology transfer, as necessary.

- *Other issues*: Require that projects to provide public services observe the environmental, labor and health standards established by the Government.

These policy considerations and negotiating guidelines would generally apply to all infrastructure and public service projects; their detailed application may nevertheless differ between different public services, e.g., electric power, telecommunications, ports, toll roads, water and waste disposal. Chapter VI of the main report applies these basic negotiating guidelines and parameters to typical issues that arise in private power projects, and derives some specific suggested positions to be taken by the Government vis-a-vis private sponsors.

It is important to note that Indonesia's negotiating position is greatly strengthened by its relatively greater access to the international financial markets, as well as the evolving capacity of domestic capital markets to provide all or part of the required financing for these projects. It is noted that recent expressions of interest and proposals from the private sector to the Government for the provision of private power generation are based on models developed to facilitate private sector finance in the development of infrastructure projects in countries where access to international finance resources is highly restricted, or where the private sector itself has limited resources. Indonesia is in a position to raise the foreign finance for new power infrastructure projects, even a sizeable one. The domestic financial markets, which are developing in an orderly manner, could also support the local currency finance requirements for such a project. The operational significance is that the Government always has the option to finance the "next" project through sovereign borrowing or by means of local private sources, which greatly strengthens the negotiator's hand, and allows the Government to enter into agreements which minimize its costs and risks.

## G. Basic Elements of the Policy Framework

The importance of developing a private investment program to provide public services, and the widespread impact that this will have on the economy, underscore the need for a sound and orderly process in moving to implementation of private participation. For maximum success to be achieved, the process should entail a policy framework with the following elements put into place in approximately the order shown:

- <u>Develop Cabinet-level consensus</u>: Develop a consensus at the Cabinet level regarding the definition of the objectives, including the broad parameters of agreements or arrangements that the Government would find acceptable.

- <u>Define an acceptable security package</u>: Reach agreement on the main components of an acceptable security package covering both financial and implementation issues.

- <u>Specify laws and regulations of general applicability</u>: Specify the laws and regulations of general applicability that will be expected to apply to private participation, especially those pertaining to health, safety, environmental standards, and labor.

- <u>Define basic pricing principles and parameters</u>: Clearly define for each service the principles that will set the limits on acceptable pricing terms.

- <u>Prepare a statement of the Government's role by sector</u>: Prepare an unambiguous statement with respect to each service sector (power, transport, etc.) of the role that the Government envisions for the private sector and the arrangements it would find acceptable, incorporating as appropriate the objectives, the structure of the security package, the public policies impinging on potential projects, and the guidelines for acceptable pricing.

- Prepare standard agreements: Prepare in standard form the key agreements that will make up the security package for each project in each sector which would set out the rights and obligations of the parties, and embody the range of policy decisions as made by the Government with respect to financing, pricing and implementation issues.

- Prepare standard terms of reference: Prepare complete and clear terms of reference for the request to make proposals associated with each project the Government desires to promote.

It is highly desirable, if not essential, that these policy components be in place prior to negotiating any major private project to provide public services. A recent, unsatisfactory experience with the private power bidding process demonstrated the need for the Government to first install the basic policy framework and clearly understood institutional procedures prior to proceeding with additional bids in any sector. This is critical if the Government is to retain credibility as a party to negotiations with private sponsors, and if both the Government and project sponsors are to have a clear basis on which to negotiate.

### H. Institutional Arrangements

To achieve significant private participation in an efficient and timely fashion within the guidelines that emerge from the Government's policy-making process will require appropriately designed institutional machinery. A number of suggested guidelines regarding appropriate institutional arrangements include:

- Committee size. The committee charged with the responsibility of implementing private programs should be as small as possible, while still representing the main interests of the Government (technical, economic and financial). This implies a committee as small as four to six people.

- Committee staffing. Such a committee should be staffed at as high a level as possible, and it should be able to meet as frequently as necessary. It could be assisted by a broader group of resource persons drawn from relevant Government agencies.

- Committee support. The committee must have adequate and quick access to the right kinds of highly focused expertise (legal, commercial, financial) that could be drawn upon on an as-needed basis. If a substantial number of projects, or if large and complicated projects are to be negotiated, then consideration might be given to establishing a full-time executive director or chief of staff and a secretariat to further support the committee's efforts.

- Degree of negotiating authority. Negotiating members of the committee must not be presented to private sponsors as the "final" decision makers. They should always have recourse to a higher decision-making body during the process of negotiation.

Exhibit 1 demonstrates how an institutional framework in line with the suggested guidelines listed above could be established using the private power sector as an example.

## I. Technical Assistance Requirements

### 1. Factors Shaping the Nature of GOI Technical Assistance Requirements

There are a number of factors and conclusions drawn from experience to date that shape the appropriate definition for further policy and technical assistance:

- The Government continues to have a significant--and growing--interest in, and commitment to, securing private participation in the provision of public services

- A lack of consensus at the top level of Government on what the objectives are and how they should be achieved remains the key, fundamental problem

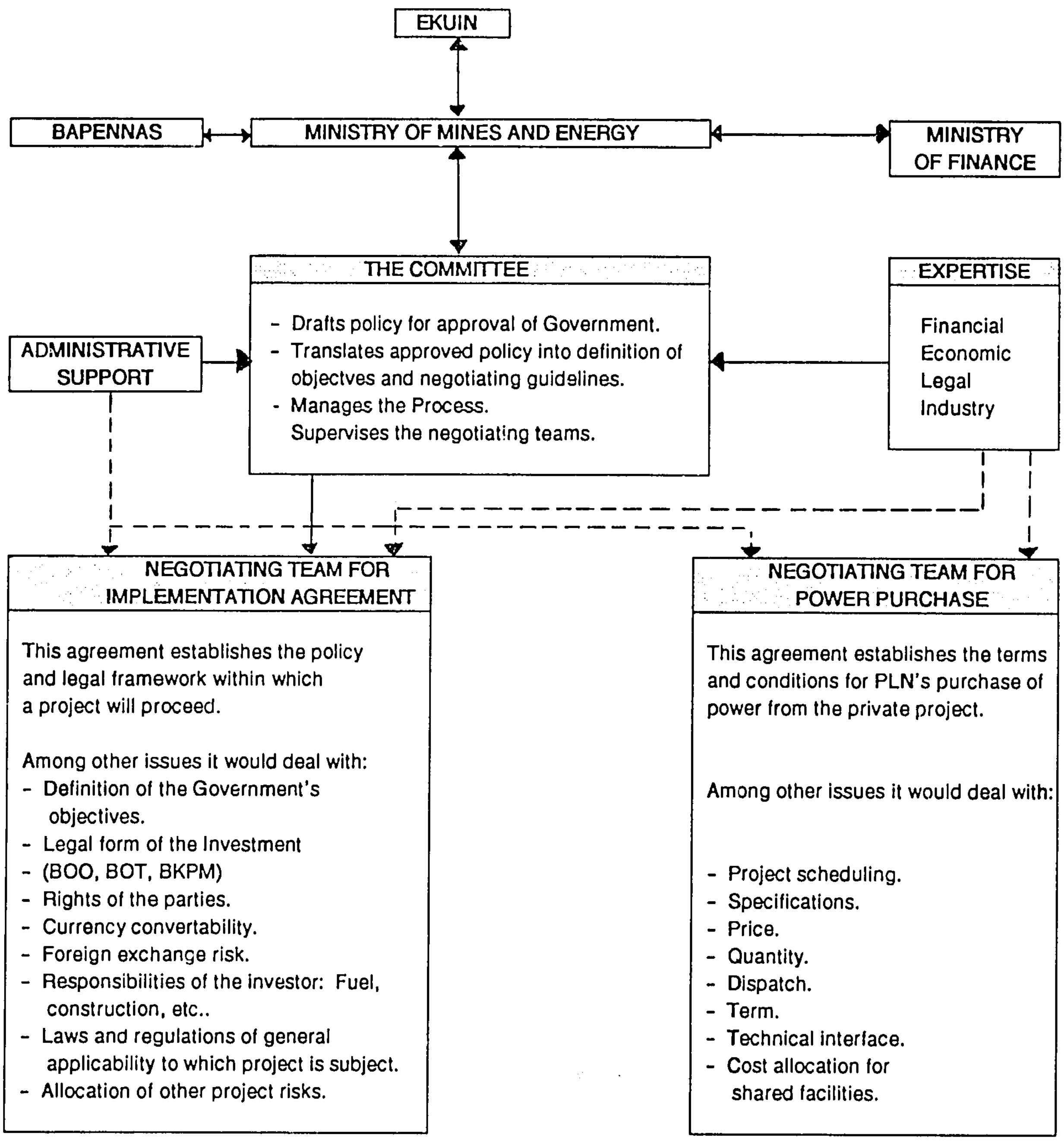
- Given the size and complexity of carrying out private provision programs, and the types of highly-specialised skills needed, governments can benefit significantly from appropriately-targeted technical assistance inputs across all sectors.

Level of Government commitment. Despite the initial difficulties in the power sector, there seems to be little doubt that at the top level of Government there is a significant, and growing interest in securing private participation in power generation to help break the power supply bottleneck. In addition, there is

Exhibit - 1

NOTE: There are a number of ways in which the implementing machinery can be organized. The following schema is suggested for implementing private power in the Indonesian context.

# PRIVATE POWER DEVELOPMENT



widespread recognition among the top policy makers that serious potential bottlenecks in the other infrastructure sectors threaten to constrain economic activity, particularly inadequate capacity in telecommunications, transportation, and urban services. There also seems to be a general recognition in the top ranks of Government that the scale of effort and finance that will be required to avoid these capacity shortfalls makes it very desirable to enlist a growing participation in the private sector in these areas as well.

Lack of consensus. A principal conclusion drawn from this engagement is that the logical sequence for the implementation of Government policy formation and decision making, as outlined above, is not being followed. The less than satisfactory outcome regarding the Paiton Private Power Project bid is a case in point: the necessary starting point--a consensus at the top level of Government--has not been achieved, resulting in the lack of an adequate policy framework to guide the process of securing private participation in a manner acceptable to all parties. Given the current situation, it is clear that the most pressing need is to lay the proper foundation at the consensus and policy levels for what it is hoped will be an extensive, long-term and high-value process of private participation in the provision of public services. To proceed without such a foundation runs serious risk of unsatisfactory results.

The utility of technical assistance inputs. Defining and implementing the Government's program of private participation requires expert financial, economic, commercial, technical and legal skills. Much of the body of skills required to carry out a private provision program can be mobilized from within the Government and the sector. However, at key points it will be necessary to supplement this with technical assistance inputs. In fact, given the size and complexity of the task at hand, it is reasonable to assume that the Government could benefit from varied types of technical assistance across all sectors, some sustained over time.

### 2. GOI Guidance on Technical Assistance Requirements

Government officials have offered the following initial guidance to shape the appropriate definition for further assistance:

(1) Additional policy-level assistance is required to assist the Government with the analyses necessary to support the further development of an overall policy framework and broad negotiating instructions applicable to all sectors.

(2) There is an immediate need for assistance in the power sector. Prior to proceeding with additional private power bids an interim period is required to more fully

establish a policy and procedural framework to more effectively guide the project selection and negotiating process.

(3) Assistance in other sectors, including telecommunications, transportation, and possibly urban services, should also be made readily accessible to the Government to be utilized on an as-needed basis.

In the power sector, during the interim period described in (2) above, assistance is required on an urgent basis from various specialists to support and facilitate a policy decision-making process leading to the development of a standard Implementation Agreement (IA) and Power Purchase Agreement (PPA). Once these basic documents are in place, embodying the consensus and multiplicity of policy decisions required by the Government in arriving at the various terms and conditions contained in these agreements, institutional issues can be more readily addressed, and standard terms of reference can be developed. Specialists are required in policy analysis, finance, private power business and economics and, toward the end of process, legal matters.

### 3. Suggested Technical Assistance Action Program

A review of the GOI's technical assistance needs suggests mounting a two-stage effort, as follows:

Phase I: A six-month period during which the emphasis is on supporting the definition of the objectives and the alternatives facing the policy makers in the overall private provision program. This phase could be made up of three components:

(1) Overall Policy Framework: Additional policy-level assistance to support and facilitate the Government's efforts in formulating a policy framework and broad negotiating instructions applicable to all sectors. The objective is to assist, as appropriate, in the analyses necessary to support the process of obtaining a consensus in the definition of program objectives, the definition of an acceptable security package, and the specification of laws and regulations of general applicability under the program.

(2) Private Power: Assistance to meet the specific needs of the private power program during the upcoming interim period as envisioned by the Government, resulting in a standard IA and PPA (as discussed above).

(3) Other Sectors: Assistance to support the Government's efforts in defining industry-specific programs in sectors other than power. The objective is to provide

the Government with inputs that provide a basis for preparing statements containing the role expected of the private sector in providing services, as well as the Government's objectives, policy framework and negotiating parameters.

The categories of specialists required during this six-month period, including preliminary level of effort estimates (stated in months), to carry out the three components listed above, include the following:

| | Cmpnt 1<br>Policy Frame | Cmpnt 2<br>Power Sector | Cmpnt 3<br>Other Sectors |
|---|---|---|---|
| Team Leader/Policy Advisor | 2 | 2 | 2 |
| Utility Industry Specialist(s) | 2 | | 2 |
| Private Power Industry Spec. | 2 | 2 | |
| Private Power Economist | | 2 | |
| Finance Specialist(s) | 2 | 2 | 2 |
| Legal Counsel | | 1 | |

<u>Phase II</u>: In carrying out Phase I, it should be possible to assess on a firmer basis the scale of the continuing effort, and the specialist needs required. It is anticipated, however, that Phase II could entail adding up to two additional resident consultants--a broad-gauged public utilities development advisor and a finance specialist--to provide assistance on an ongoing basis across the entire spectrum of policy and implementation related matters that the Government will confront in carrying out a private provision program in the years ahead, including:

- o Clarifying issues and alternatives as the Government continuously refines its objectives
- o Advising on the design and development of implementing procedures and processes
- o Analyzing the determinants of additionality in both financial and the efficiency terms
- o Defining selection criteria for projects, sponsors and investors reflecting both general and sector-specific considerations
- o Formulating proposal evaluation measures
- o Developing negotiating instructions

- Pre-qualifying potential sponsors
- Drafting terms of reference and requests for proposals
- Evaluating complex financial arrangements
- Drafting and continuously refining standard contracts
- Assisting in negotiations which are oftentimes long, complicated and potentially contentious.

These resident specialists could be supplemented by the inputs of short-term specialists on an as-needed basis.

### 4. USAID-Financed Assistance

USAID/Indonesia, in view of the potentially significant developmental benefits of private participation to Indonesia's economy, strongly supports the Government's emerging policy in this area and is prepared to provide additional policy and technical assistance upon request. USAID is well positioned and equipped to make a unique contribution through the provision of additional assistance, both short and long term, and has indicated that it wishes to remain as responsive as possible to Government requests for assistance.

## II. INTRODUCTION

### A Background

A proper balance between the capacity to provide public services and the overall level of economic activity is essential to permit continued economic growth in Indonesia. Infrastructure constraints are now threatening to rein in the rapid growth experienced in recent years by Thailand. India and the Philippines are examples of countries whose current rate of growth are constrained by their limited ability to expand capacity of their public services, especially power and transport.

The response of the Indonesian economy to the series of reform packages and restructuring measures adopted by the Government has been vigorous. Current and prospective levels of growth will require increased infrastructure capacity at a faster rate than previously envisioned. This in turn will require levels of investment that may well tax the Government's capacity to finance all public sector facilities along with all other claims on the Government's revenues.

A precise measure of the scale and investment required to meet the economy's expanding demand for infrastructure services is not readily available. Therefore, an estimate of the potential role of the private sector in the provision of public services cannot be given with any precision at this time. Arriving at a meaningful estimate is complicated by the uncertainty as to the rate of economic growth that will be actually experienced, and, indeed, of the interactions between the growth and the avoidance of infrastructure bottlenecks.

Nevertheless, the likely orders of magnitude can be derived from the assessments currently underlying long-term planning. PLN projects that annual investments in the order of US$ 3 billion will be needed through this decade to meet its demand estimates for that period. It has been estimated that Perumtel will require investments of US$ 6.3 billion to meet a relatively modest target for telephones of 2.34 lines per 100 people by the year 2000. Together, these estimates, all in 1990 prices, suggest that the scope for private projects could well run to US$ 1.5 billion per year during this decade for these two sectors alone. That would still leave the responsibility for the finance of more than half of all new capacity to be provided by the Government. To this would need to be added the requirements of private participation in the provision of the services of roads, ports, airports, and urban services.

For this reason, the Government is exhibiting a significant--and growing--interest in and commitment to securing private participation in the provision of public, or infrastructure services. The scope for private participation is most likely to be greatest in electric power, transport (including toll roads, harbors, and airports), telecommunications, and urban services such as water treatment and supply and waste disposal, although opportunities may arise in other public services areas.

Several proposals to implement such projects already have been put forward by private sponsors. The evaluation of these proposals, the solicitation of other proposals, the selection or rejection of individual proposals, and the effective implementation of selected projects will require a sound policy framework. That framework should, as unambiguously as possible, specify the Government's objectives. On the basis of those objectives, the framework would then define the appropriate role for private participation and specify negotiating parameters to guide discussions with the project sponsors.

It is very desirable that the framework should be in place before individual projects are implemented on an ad-hoc basis. Otherwise, there is too high a probability that the total program will be significantly sub-optimal. This is true for all sectors, but can be particularly critical for a sector like power for which system-wide planning is so important to obtain a least cost solution. Since the issues that must be addressed span technical, fiscal, and economic questions, the policy framework must be based on a consensus among the relevant technical and economic Ministers. Thus, a dialogue at that level is ideally the first step in the process.

## B. Objectives and Scope of Work

The objective of this report is to provide the Government of Indonesia (GOI) with a report on the private provision of public services which suggests an initial policy framework for consideration by the GOI, the elements of which would serve as evaluation criteria and negotiating parameters as the Government considers proposals for private investment in the provision of public services. The scope of work includes:

- Specification of the economic rationale and consequences to support a significant departure in policy on the part of the GOI

- Definition of the evaluation criteria (financial, commercial, and institutional) for use by the Government in evaluating proposals for private investment in the provision of public services

- Identification of key negotiation parameters which typically must be addressed in conducting negotiations with private sponsors, including recommendations regarding the most optimal positions that the Government should take vis-a-vis sponsors.

In view of the priority currently granted by the GOI to private power, the above elements of the scope of work are targeted to this purpose. Nevertheless, the majority of the evaluation criteria and negotiating parameters which pertain to the power sector are also germane to other sectors that the Government may wish to give consideration (e.g., telecommunications, ports and transport, water and waste disposal).

Suggestions are also made with respect to areas where the Government may benefit from additional technical assistance in pursuit of its program to provide public services privately, and which may, in turn, serve as a basis for further assistance to be provided by USAID.

This report was prepared by Dr. William Hollinger under the auspices of USAID/Indonesia's Financial Markets Project (FMP) and APRE/EM's Financial Sector Development Project (FSDP). Dr. Hollinger drew on technical support from Price Waterhouse's International and Utilities Practice Units based in Washington, D.C.

### C. Contents of the Report

In accordance with the scope of work, the report contains the following Chapters:

- Chapter III defines the rationale and appropriate role for the private provision of public services in the Indonesian context.

- Chapter IV identifies a range of criteria and parameters that shape the guidelines for decision makers and negotiators. These include primarily policy, planning, financial, and commercial issues applicable to all infrastructure sectors. In addition, there are technical criteria that are quite specific to each sector of public services.

- Chapter V summarizes the implementation process that would be desirable to assure that the private provision of public services is secured in a sound and orderly fashion, and that the Government's objectives are achieved economically and efficiently.

- Chapter VI applies these decision rules to the electric power sector and derives some suggested specific negotiating guidelines for that sector.

- Chapter VII discusses in general terms the issues in the telecommunications sector.

- Chapter VIII discusses areas where the Government could benefit from technical assistance, and presents a suggested plan of action for USAID to consider in order to further assist the GOI in its efforts.

## III. RATIONALE FOR THE PRIVATE PROVISION OF PUBLIC SERVICES

### A. Arguments to Provide Public Services Privately

There are two main arguments advanced for an enhanced role for the private sector in the provision of public services: the financing argument and the efficiency argument.

#### 1. The Financing Argument

The financing argument addresses the problem of meeting the investment required to support the increase in public services required by an expanding economy. The size and location of the private participation that is needed can be defined in terms of the supply and demand balance for public services as determined by comparing:

- o The derived demand for infrastructure services based upon the expected growth of the economy, with
- o The public sector financial capacity to meet that growing level of demand for public services.

Any gap between these two magnitudes defines the potential bottlenecks that will impact on the economy's capacity to grow, and measures the magnitude of the need for private participation in creating and delivering public services.

Two things should be noted about this definition. First, it is primarily quantitative, measuring the scale of the financing needs that the private sector would need to provide if economic activity and growth are to stay on course for any given level of public sector budget support for growth of these services. It does not address the interaction between the claims of the Government and private investors on the international and financial markets. We will return to this point below. It also does not address other aspects of private participation such as managerial efficiency, access to technology, increased competition, etc. Those issues are dealt with by the efficiency argument for private participation.

Second, it makes it clear that there is a continuing role for private participation. The need for private participation does not arise from a crisis caused by a temporary shortfall in revenues. or a sudden spurt in needs, or a mistake in planning. The need arises because a rapidly growing economy will generate expanding demand for public services at a pace that cannot effectively be met by the Government, or can be met by Government only at the cost of cutting back on other essential public expenditures that may not be as suitable for profit-motivated private participation, such as education and defense.

### 2. The Efficiency Argument

The efficiency argument for private provision of public services rests on two propositions:

- The Government's ability to provide additional capacity for public services is not limited solely by financial constraints
- Increasing the number of participants in a market increases competition which tends to restrain costs and prices.

The appropriately skilled human resources and the management capacity that the Government can mobilize to support an expansion of public services are limited. Moreover, it is generally thought that the operating modalities in private enterprise may generate more effective incentives to keep costs down and to be responsive to shifting patterns of demand.

It is important to keep in mind both of these points--the long-term need for private participation and the non-financial dimensions of the limits on the Government's capacity to support growth in public services--when formulating a policy framework. If the problem was only financial and temporary then the right policy would be different from that which is, in fact, appropriate to sustain Indonesia's growth at the desired and possible rate.

Thus, while there are important efficiency reasons for considering increased private participation in the public services sectors, and there can be many cases in which efficiency tips the scales in deciding to go forward with particular projects, at the transactional level the decision making and negotiations are essentially about alternative financing arrangements. This is a point that will be discussed at greater length below in the context of the power sector.

## B. The Potential Benefits

An expanded role for the private sector in the provision of public services and infrastructure facilities potentially has two major advantages for national development:

- Expanded capacity for the provision of public services
- Increased efficiency in the provision of public services.

### 1. Expanded Capacity

The finance provided by private sponsors does not come out of Government revenues. Therefore, they are assumed to be additional to the resources otherwise available to invest in the provision of public services. For this benefit to be real it is necessary that the financial resources committed by private investors are, in fact, a net addition to the resources available to the economy. This requires that a number of questions be considered in evaluating individual proposals. Among the more important would be:

- The degree of recourse
- The net impact on tax receipts of the proposed terms
- Any element of "crowding out" that the proposed financing might cause.

If there is real additionality in the resources provided through private participation, then there will be lower claims on the national budget for any given level of public services. We will return to these issues below when defining financial objectives.

### 2. Increased Efficiency

Increased efficiency in the provision of public services will arise to the extent that the private sector can provide a mix of:

- More or better management
- Better technology
- Better services, especially greater options open to consumers
- Greater competition.

There are, however, costs as well as benefits of private participation. The costs and benefits must both be assessed and this assessment must shape in an important way the Government's policy framework and negotiating parameters.

## C. The Potential Costs and Limits

### 1. Increased Financial Exposure

Additional finance for expanded growth in capacity constitutes an increased claim on the debt servicing capacity of the economy. The fact that the obligator is a private party is not relevant to the broader issue of the limits to which the economy (not the Government only) can comfortably support a corpus of debt. This applies to both domestic and foreign supplied debt finance, and is, in a sense, the other side of the coin of the crowding out issue noted above.

Given the importance to Indonesia's continued development of maintaining the international credit worthiness of both public and private sector borrowers, the foreign exchange element in these claims sets a limit on the prudent build-up of the obligations. The objectives of monetary policy set limits on the provision of domestic debt finance. The extent of recourse to the Government in the financing arrangements determines the Government's direct exposure.

### 2. Increased Cost of Finance for Public Services

Governments, generally, can borrow on better terms than can a private investor. By the very fact of being sovereign, if a government is creditworthy, as Indonesia is, private lenders are willing to provide funds at rates which are effectively below the prime rates they charge their private clients. Moreover, developing country governments have access to non-commercial finance at concessional rates of interest. Nevertheless, there are limits to a government's ability to raise money in these ways. This is particularly true in the area of private provision of public services, where the financing requirements in rapidly growing developing economies are extraordinarily high. Hence, the cost of finance for public services on a fully private basis will tend to be higher.

### 3. Increased Inflationary Pressures

Expanded infrastructure investment based on finance that is additional to that otherwise available will generate additional pressures on prices and on the supply of real resources. This can significantly increase the inflationary pressures in the economy. Obviously, this is not a reason to reject private participation with true additionality. Like so many of the difficult decisions that a government must always be making, the question is to get the tradeoff right. Without private participation and additional finance, bottlenecks will continue to arise that will themselves create inflationary pressures and constrain growth. The objective is to exactly balance the inflation reducing and inflation increasing propensities of private participation. In the case of Indonesia, a prudent, balanced program is likely to accomodate a quite significant level of private participation.

### 4. Increased Coordination Requirements

The introduction of private participation into activities that were previously the province solely of the Government creates a number of operational interfaces that did not previously exist. These, in turn, raise the needs for effective coordination of public and private efforts if the objectives of all parties are to be met. Among the more important of these would be the following:

- Coordination of each project with the plan or overall capacity developments
- Assuring a smooth operating and physical interface with other system components.

As will be discussed below, these two considerations are especially important in the process of project identification and proposal evaluation.

### 5. Security of Supply

In Indonesia, the Government, acting through designated public entities such as PLN or Perumtel, has the constitutional and political responsibility for adequacy and reliability of supply for key public services. The party responsible must always be concerned when making good on its responsibilities rests on the performance of a third party.

While one of the reasons for seeking private participation is the assumption that it will bring with it increased efficiency and competition, private parties also can fail to perform. This could have repercussions beyond the project itself. For example, when a private power generation project is approved, adjustments will be made in the program for the total system development to accommodate the expected output of that project. If there is a serious shortfall in performance, for whatever reasons, on the part of the private sponsor this can have a detrimental impact on PLN's ability to meet its responsibilities.

The recapitulate, the need for and appropriate role of private participation is defined by:

- o The impact of capacity constraints on the economy's ability to grow
- o The balance between the benefits and costs.

## IV. SELECTION CRITERIA AND NEGOTIATING OBJECTIVES

### A. Introduction

On the basis of the considerations above, there are two overriding criteria that each proposal for the private provision of public services should meet:

- o First, the proposal should serve an appropriate need as established within the context of the Government's overall private provision program. It should break a constraining bottleneck, or avoid one from arising.
- o Second, the project should provide capacity and services that could not otherwise have been provided, or could not have been provided more economically, by the public sector.

These two criteria assure that a desirable private sector project will provide important additionality to the economy, not just substitute for an equally available and effective public sector project. This additionality can be with respect to various components of a project. Generally, and most fundamental, the finance should be additional to what the Government could otherwise have mobilized. The project also could be expected to enhance or expand the management capability available to the economy; r have access to better technology; permit a better spread of risk bearing among the parties in the economy; or some combination of all these elements.

The parameters set out below for the financial, economic, and commercial aspects of a project are designed to assure that the projects that are selected have these desired characteristics. Their application should increase the efficiency of the total system and ensure that services are provided by the proposed project at a cost equal to or less than those services would otherwise be available to the economy.

### B. Specific Criteria and Negotiation Objectives

#### 1. Minimum Recourse

There should be as little recourse to the Government as possible, as recourse directly reduces the element of additionality in finance. In practice, there will necessarily be a trade-off between recourse and eliciting a desired investment, but in a satisfactory end result there must be a significant net balance of additionality. To assure this, there should be no assumption of direct financing risk by the Government. Assurances as to the financial performance of state-owned entities who are parties to the commercial arrangements (e.g., PLN as a buyer of power from a private power generator) should be the main form of "comfort" provided by the Government to a project's lenders. No construction (completion) risk should be assumed by the Government. In particular, if the investment is to be truly a private investment, then the Government should not be a party to any cash deficiency guarantee that the project's lenders may require.

### 2. Convertibility and Exchange Risk

Assurances by the Government that the present policy of full convertibility will apply to the project throughout its life will probably be necessary. The issue of foreign exchange risk will need to be resolved in all cases requiring major foreign exchange expenditures for investment and/or maintenance if the project is to be feasible for a private sponsor. This will be the case equally for foreign or domestic investors. The Government's objective should be to minimize its assumption of exchange risk to that proportion of sales proceeds necessary to service foreign borrowings and the foreign exchange costs of operations.

On the other hand, if the project does not require substantial foreign exchange expenditures (perhaps a toll road could be a case in point), the Government should resist the assumption of exchange risk to service foreign borrowing, unless the Government precluded domestic borrowing for a foreign partner.

Another issue that will need to be resolved is the question of the foreign currency value of profits in the case of a foreign sponsor. If the project would not go forward without some assurance on this point, the Government will need to decide in each case whether the perceived benefits of the project outweigh the assumption by the Government of the necessary exchange risk.

There should be no guarantee of profits or rates of return. This is a different question from that of the foreign exchange value of whatever profits are earned by the sponsor. Obviously, the private sponsor will not proceed with the project unless in his judgment the total set of terms and arrangements provide a reasonable expectation that he will earn his desired rate of return. It is up to the sponsor to convert that expectation into reality without any further help or assurance from the Government.

### 3. Financing Format

What are the advantages and disadvantages of alternative project financing formats; e.g., Build-Own-Transfer (BOT), Build-Own-Operate (BOO). A BOT project is likely to be the preferred structure for a number, but not all, project sponsors. If the sponsors are mainly equipment suppliers or construction companies they will strongly prefer a BOT over a BOO project. If the project sponsor is a long-term investor rather than a supplier he will probably prefer the BOO format. A BOO project has the advantage that, while both BOT and BOO projects entail complex negotiations and arrangements, a BOO format is simpler and requires less complicated negotiations and fewer agreements than does a BOT format. For the Government an important advantage of BOO is that it provides for meaningful competition with public suppliers of public services as well as with other private suppliers, if there are any.

In considering the relevance of the BOT concept in the Indonesian context two points should be noted. First, while there has been considerable interest in and discussion of this approach over the last decade, and a number of projects have been suggested in several countries, few major projects have been fully implemented and brought on stream. The Hopewell Project in China has recently gone on stream and its Project in the Philippines is now about to begin construction. The agreements and financing for the Hab River project in Pakistan are slowly winding their way through the process of approval or ratification. After years of talk and abortive negotiations with many international parties on projects in several sectors, Turkey has still to see final agreement on any project.

Second, the BOT format is primarily designed to address the problems of financing projects in countries with little or no access to international finance and weak domestic capital markets. In Pakistan and the Philippines, the World Bank and the ADB have assisted in the establishment of funds to facilitate government equity in both BOT and BOO projects. This has been done on the assumption that such participation is necessary to give comfort to international lenders. Such comfort is needed because without it the self-imposed limits by lenders to their country exposure for those economies would preclude lending for the projects concerned. For Pakistan, moreover, lending for the lenders to be forthcoming it was required that recourse to the government had to be backed up by government equity participation.

This is not the case for Indonesia. The Government and the economy both still have relatively free access to international financial markets. This should certainly strengthen the hand of the Government's negotiators. Recourse should be minimized and the Government should avoid taking equity positions in privately-sponsored public services projects.

### 4. Pricing of the Services

To assure that a private project is not a higher cost alternative, a benchmark must be identified that sets a ceiling on the price to be paid by a public entity for the service when provided by private sponsors. This benchmark would also be necessary as a guideline in the supervision of the sector when the buyers of privately provided services are themselves private parties. More generally, prices should be driven by market forces to the maximum extent possible. Among other things this means that, in defining the basis for prices to be paid for privately provided services, it is the true economic costs that are relevant. The costs of providing these services from public sector providers would need to be adjusted to eliminate the effects of any subsidies the public sector entity may be enjoying when public sector costs are used to determine prices to be paid to private sector providers.

When long-term purchase contracts are required particular care must be paid to the price adjustment or escalation clauses. These clauses should be designed to assure that adjustments are driven by changes in costs or by changes in market conditions that directly impact the project. Automatic adjustments triggered by changes in indices or prices that are unrelated to the operations of the project itself should be ruled out.

When private provision of public services increases competition, the Government must consider whether or not it is desirable for it to maintain a supervisory or regulatory role. If a Government-owned entity such as PLN or Perumtel is the sole purchaser of the service, this issue could be viewed as dealt with in the pricing arrangements between the parties. When, however, there are multiple purchasers from the private sector--for example, a private generator of electricity selling to many tenants of an industrial estate or a private operator of a port facilities providing services to private sector shippers--equity, efficiency, and other public policy considerations require that prices, and in some sectors questions of technical standards and compatibility, be subject to review or approval by the Government.

### 5. Effective Implementation and Security of Supply

As demonstrated above, if the project is to provide services that are critical to effective and efficient operation of the economy or a segment of the economy, then the Government needs to be reasonably certain that those services will be available where and when promised. This is particularly true if the project substitutes for a publicly financed capacity that would have been felt necessary if the private project had not been on offer. To secure a desirable level of comfort in this regard will entail, in particular cases, the need for implementation agreements to establish the timetable and framework for implementing the project. The implementation agreement or the commercial terms, or both, also might well need to contain penalties and, possibly, bonuses for performance below or above a standard defined in the agreements.

### 6. The Applicability of Administrative and Legal Regimes

To achieve the objective of increased efficiency and reduced costs the project should be treated as a purely private investment. That would mean, among other things, that procurement and implementation by the project sponsors should be freed of all administrative requirements and procedures that may apply to the comparable public entity supplying the same service simply by virtue of the public nature of that entity; i.e., requirements deriving from the Budget Implementation Law or other public sector procurement regulations. On the other hand, all such projects should be subjected to laws and regulations of general applicability to similar private operations. In particular, equity and developmental considerations require that projects to provide public services observe the environmental, labor, and health standards established by the Government.

## C. Summary of Selection Criteria

To recapitulate, a proposal for the private provision of a public service should be favorably considered if:

- It would make a net addition to the infrastructure services that would otherwise be available and the failure to supply those services could constrain the economy's growth

- The financing for the project does not lead to either an excessive foreign exchange exposure for the economy or complicates the Government's own dealings with the international capital markets

- If a proposal meets those criteria, then the Government's negotiators should seek to:

  - minimize recourse to the Government with respect to the financial obligations of the project and in particular avoid the acceptance of any construction or operating risk

- assure that the price of the services (either to the Government entity such as PLN or to private sector purchasers) is less than or equal to the price of the services otherwise available to the user

- balance the investor's need for secured sales revenues ("take-or-pay" provisions, or their equivalent) with security of supply or performance assurances

- establish pricing mechanisms that reflect market conditions

- avoid profit guarantees

- assure equity as between different consumers or classes of consumers

- observe sound environmental and health standards

- achieve as much competition as possible, which would mean to favor BOO over BOT arrangements whenever possible or feasible.

These policy considerations and negotiating guidelines would generally apply to all infrastructure and public services projects. Their detailed application may differ between different public services--electric power, telecommunications, ports and toll road, water, and waste disposal. In addition, the characteristics of the various public services will give rise to service-specific requirements in the terms and arrangements for projects supplying each service.

Exhibit 1 contains additional information regarding a suggested negotiating framework for the Government follow.

# V. THE IMPLEMENTATION PROCESS

## A. Introduction

Implicit in the above discussion of private participation in the provision of public services are the determinants of the best way to proceed if that participation is to be beneficial and the Government's objectives are to be achieved.

First, the issues common to all sectors are predominate in establishing the desirable policy framework. From the Government's point of view, private participation is primarily a question of an alternative way of financing the necessary investment. This is a question of both the additionality of financial resources and efficiency. Can private sponsors provide the facilities at a lower investment cost given their cost of money, or can they provide facilities that could not otherwise have been financed? Can the private sector operate infrastructure facilities more efficiently and deliver the services at unit costs that are lower than or equal to the costs of a public sector entity? These issues apply to any sector in which private participation is proposed.

Conversely, the supply and price of these services have very important impacts on the macro-economic performance of the economy. They are critical to the successful growth of the economy. The costs at which they are available are a significant determinant of the cost structure in the economy, shaping both competitiveness and inflation. Again, this is true whatever the sector.

## B. Key Policy Framework Elements

These characteristics of importance and widespread impact underscore the need for a sound and orderly process in moving to implementation of private participation. For maximum success to be achieved the process should entail a policy framework with the following elements put into place in approximately the order shown:

- o A broad consensus at the Cabinet level on the definition of the objectives and the broad parameters of agreements or arrangements that the Government would find acceptable.

- o Agreement on the main components of an acceptable security package covering both financial and implementation issues.

- A specification of the laws and regulations of general applicability that will be expected to apply to private participation, especially those pertaining to health, safety, environmental standards, and labor.

- A clear definition for each service of the principles that will set the limits on acceptable pricing terms

- The preparation of an unambiguous statement with respect to each service sector (power, transport, etc.) of the role the Government envisions for the private sector and the arrangements it would find acceptable, incorporating as appropriate the objectives, the structure of the security package, the public policies impinging on potential projects, and the guidelines for acceptable pricing.

- The preparation in standard form of the agreements that will make up the security package for each project in each sector.

- The preparation of complete and clear terms of reference for the request to make proposals associated with each project the Government desires to promote.

It would be highly desirable, if not essential, if these policy components could be put in place, in roughly the order shown, prior to negotiating any major private project to provide public services. Practical considerations in the real world are never that neat. Some negotiations may well need to take place before the full policy structure is in place. Nevertheless, it is very important that the policy framework be developed and the various documents listed above be prepared as rapidly as possible so that they can shape the process as early as possible.

It is particularly desirable that the Cabinet-level consensus on objectives and a consensus among the top economic, financial, and planning decision makers on what will be acceptable in the security package be in place to guide negotiations from the beginning. If negotiations take place with the project sponsors without this consensus and the participation of the economic Ministries, there is the risk that draft agreements will be presented to the Government for approval that contain elements of financial exposure or the policy implication that the Government is reluctant or unwilling to endorse. This will raise real questions as to the credibility of the Government as a party to negotiations. It must be remembered that any implementation agreement for a private infrastructure project will be the product of long, arduous and costly negotiations. Thus, to find it unacceptable after that process has been gone through would be embarrassing to say the least.

It is equally desirable that unambiguous, sector-specific "opportunities" statements, terms of reference and request for proposals for the individual projects, and draft security package agreements be ready prior to extensive negotiations. This is necessary if both the Government and the project sponsors are to have a clear basis on which to negotiate. That is in the interest of both parties. From the Government's point of view, it is well to remember that it is always better to negotiate from your draft, not the draft prepared by the other party.

## C. Institutional Arrangements

To implement the evaluation, selection, and negotiation of projects for private participation within the guidelines that emerge from the process described above will be a challenge. To achieve significant private participation in an efficient and timely fashion will require appropriately designed implementation machinery. The committee charged with this responsibility in any sector should be as small as possible and still represent the main interests of the Government--technical, economic and financial. This might imply a committee as small as four to six people.

Such a committee should be staffed at as high a level as possible, and it should be able to meet as frequently as necessary. It could be assisted by a broader group of resource persons drawn from relevant Government agencies if that would seem helpful. The committee must have adequate and quick access to the right kinds of very focused expertise that could be called upon as the need arises. Legal, commercial, and financial skills of the highest order will be required in all sectors involved. If a substantial number of projects, or if large and complicated projects are to be negotiated, then it might be desirable to consider supporting the committee with a full-time executive director or chief of staff and a secretariat. If that sounds too elaborate, it must be borne in mind that a successful effort to attract private power would involve dealing with projects totalling several billion dollars in investments.

In line with these guidelines, Attachment 2 presents a suggested schema for implementing private power in the Indonesian context.

## VI. APPLYING THE NEGOTIATING PARAMETERS TO THE ELECTRIC POWER SECTOR

### A. The Types of Agreements and the Importance of Finance Issues

Electric power generation for sale to PLN for onward distribution by PLN is likely to be the predominant form that the private provision of public services takes in this sector. However, there are already proposals for the direct sale of privately generated power to industrial consumers located in industrial estates. Whether or not private distribution in any broader sense will arise as an active issue for consideration remains to be seen. Therefore, the main focus of the discussion here will be on power generation, although the analysis could be extended easily to distribution more broadly.

A large and complex set of agreements and arrangements will be necessary as the basis for a successful private power project. To illustrate the point, Attachment 3 presents a schematic diagram of a power sector BOT project. The legal, economic, and institutional conditions in a host country will determine the number and content of the agreements required in each case. However, such projects usually have entailed:

- An implementation agreement
- A power purchase agreement
- A construction contract
- A fuel supply agreement
- An operating and maintenance agreement
- A review by the Government of the financing arrangements.

An outline of the typical coverage for these agreements is given in Attachment 4.

The Implementation Agreement (IA) will deal with, among other questions, such issues as capital and income convertibility and transferability, recourse to the government or government loan guarantees or comfort, and the foreign exchange risks. These are all questions that normally would require approval and implementation by the financial authorities.

The Power Purchase Agreement (PPA) will contain pricing and price escalation clauses. These provisions could have broad macro-economic significance for future developments, especially if the project involves large sales to the national grid. Indeed, the financial issues typcially dominate the negotiations, and the financial terms finally agreed are the central terms in the arrangements for the private provision of public services. Both the investor and his bankers in any private project for provision of public services that actually gets implemented will require guarantees or significant comfort from the host government on both market risk (sales revenue) and foreign exchange risk. This is an invariable characteristic regardless of the sector or the form of the investment (BOT, BOO, etc.)

Equally fundamental, the "take-or-pay" provisions of the sales contract, the market risk comfort which is the basis for the financing of any private sector sponsored infrastructure project, will contain price adjustment or escalation provisions features that can have a significant impact on future macro-economic performance. All of this underscores that the financing issues and the financial structure is what drives these projects and which determines the entire set of business arrangements. These are the issues for which it is so important to have the guidance of the policy consensus discussed at the end of the last section.

## B. Typical Negotiating Issues and Recommended Positions

This section sets out in greater detail the issues that will arise in a project for the private provision of electric power that are additional to the purely technical and sector-specific concerns. Particular emphasis is given to financial questions, but a number of economic and commercial issues are also important and are discussed. Recommendations of general applicability are suggested. However, in evaluating recommendations and in setting a negotiating framework, there are two points that should be kept in mind.

First, while it is unquestionably urgent to augment the infrastructure capacity in the interests of sustaining a high rate of growth, there has to be the right "cost/benefit" balance. Some proposals may not be worth doing because the demands of the sponsors are too high, or they fall outside the limits set by the policy parameters and negotiating guidelines. Other projects may bring such high benefits that it is desirable to give more to secure the project than the general negotiating framework would suggest. There will be no way to avoid completely difficult judgment decisions of this type.

Second, many proposals of the type now proposed to the Government are based on models that were evolved to facilitate private sector finance in the development of infrastructure projects in countries where the government and public authorities had little or no access to international finance resources. In a number of those countries domestic financial resources were extremely limited in the private sector as well.

It is important to note that neither of these financial constraints currently exist in Indonesia to a significant degree. Indonesia still has access to new money on the international financial markets. Indonesia could raise the foreign finance for any new power project, even a sizable one. The domestic financial markets could also support the local currency finance for such a project. The problem for Indonesia arises because of the <u>scale</u> of potential infrastructure investment needs. If Indonesia attempted to finance all of its high priority investment requirements in the electric power sector through the budget and Government borrowing, it would run up against market constraints and could ultimately lose its current high credit rating. Nevertheless, the operational significance of this is that because the Government would always have the option of financing the "next" project through sovereign borrowing, the position of the Government's negotiators is greatly strengthened.

### 1. <u>Choice of Investment Format</u>

#### a. <u>Investment Format</u>

Which format will be more attractive to potential project sponsors (e.g., BOT or BOO format)? The BOT approach is attractive in those situations for which it was developed: when it is necessary to make possible private participation in large infrastructure projects where the host government had little or no access to finance, and where market and foreign exchange risks are high. In those situations project sponsors preferred, or would only consider, BOT arrangements in contrast to conventional private investment risks. This is because the classic BOT project entailed substantial recourse. In Indonesia, those conditions do not prevail. The economy's credit rating is higher than in Turkey, Pakistan, and the Philippines--typical BOT countries--and there is a long record of currency convertibility and transfer of profits and debt service. Therefore, private sponsors may be quite willing to consider, even prefer for reasons of control and simplicity, the more conventional investment model, i.e., the BOO format, even for infrastructure projects when they are in Indonesia.

> <u>Recommendation</u>: The Government should seek to avoid or minimize the capital participation, support, and guarantees that are normally part of its role in a BOT project. If the sponsor finds the BOO approach more desirable, then the Government should welcome this outcome. (See the following point as well).

### b. Advantages of the BOO Format

To what extent is the BOO format simpler to negotiate and administer? The issue of the accounting and financial settlement to be associated with the ultimate transfer of ownership does not arise in the case of a BOO arrangement. The significance of this consideration depends upon when in the economic life of the facilities the transfer is planned to take place. If the transfer is to take place when any important part of the plant's economic life will still remain, then, the issues to be dealt with could be complicated. It is to occur only at the end of the plant's economic life then, of course, the issues are insignificant. Under a BOO arrangement, the capital structure of the operating company and its investment costs are of less concern to PLN or the Government to the extent that the Power Purchase Agreement provides for a price that is attractive to Indonesia, the level of recourse or other financial exposure of the Government are acceptable, and there are strong enough security of supply guarantees.

> Recommendation: These considerations reinforce the desirability of a BOO approach if it can be achieved. This is the course being followed by the Private Power Committee in its Terms of Reference for the Paiton project.

### c. Role of BKPM

Should both formats require BKPM (Investment Board) approval? A private investment project would normally be expected to go through the BKPM approval process. A project implemented on a BOO basis is, in effect, a normal private investment. Therefore, it would be appropriate to submit such proposals to BKPM for approval. The terms of reference issued by the Private Power Committee for Paiton units 7 and 8 stipulate that proposals should be for a BOO investment. These should receive BKPM approval as is the Committee's intention.

It is possible that private participation could take place in other formats which are sufficiently different from normal private investment that the appropriate approval process would be less clear. The earlier in the life of the physical plant at which transfer of assets is to take place in a BOT project, the less is the project like a standard private investment. There might be projects that are structured more along the lines of a production-sharing contract or a pre-payment for capacity scheme. For example, Perumtel's revenue sharing arrangements for private participation are more like a pre-payment arrangement or a stretched out suppliers credit than it is like a ordinary private investment.

> Recommendation: If the project proceeds on a straight investment, or BOO, basis, BKPM approvals should be

required. If the arrangement is a BOT project with transfer significantly shorter than plant life, or otherwise unlike a conventional private investment, the appropriate approval process would be more ambiguous.

#### d. Competition

Is competition an objective? Increased capacity or, investment additionality, is the primary stated objective. If, in addition, more effective competition (or the creation of an independent performance yardstick) is an objective, then the BOO format clearly is the choice to be preferred, unless the operations of the BOT facilities can be fully independent of any Government or PLN impact.

Recommendation: This is a major political and policy decision that cannot and should not be decided on technical grounds. There are efficiency advantages to competition. There are also social and political objectives the achievement of which could be complicated by competition.

### 2. Sales Issues

#### a. Sales to PLN

Are sales only to PLN to be permitted, or are direct sales to other consumers an option that could be considered? In cases where direct sales make more sense--say to customers or in areas where existing PLN distribution networks do not exist--it would be desirable not to foreclose the opportunity for direct sales.

Recommendation: An open mind should be kept on this question. If cases arise where direct sales make more sense--say to customers or in areas where existing PLN distribution networks do not exist--it would be desirable not to foreclose the opportunity for direct sales.

#### b. Direct Sales

If direct sales by a private generator are permitted, are they to be limited to industrial consumers only, or can there be sales to the households sector as well?

Recommendation: Again, this is more a policy question than a technical issue. However, if there are to be sellers of electricity other than PLN, a regulatory or supervisory process needs to be put into place to assure stability and equity and to contain the impact of any local monopoly that might arise.

### 3. Financial Issues

#### a. Capital Structure

Are capital structure requirements to be specified? Is a minimum equity proportion in total project finance to be required?

The more the equity, the better. There are three reasons for this. First, equity, if it really is the investors own money at risk, provides the sponsor with strong incentives to be efficient. Second, equity creates a contingent liability, debt creates a fixed liability. Dividends are paid only if the operation has been successful enough to earn a profit, debt is serviceable no matter what the results. Third, equity has a favorable tax impact if interest is deductible and dividends are not. However, to set an arbitrary debt/equity ratio, such as 70/30 or any other numbers, serves little useful purpose. Such a rule can be irrelevant as a selection criteria, and can be quite inappropriate in particular cases.

> Recommendation: The terms of reference that accompany requests for proposals should contain a statement along the following lines:
>
> > "While a minimum level of equity will not be specified for this project, the Government prefers a higher share of equity in the project's capital to a lower share. The debt/equity ratio proposed will be one of the factors taken into account in evaluating your proposal. The Government reserves the right to raise the question of an increase in the equity proposed if it is decided to proceed to negotiations."

#### b. Government Review of the Finance Package

Should the total finance package (structure, rates, and sources) be subject to Government review? The problem of "crowding out" was noted above. If enough projects for the private provision of public services in the power and other sectors are approved, the sponsors of those projects will be seeking funding on the international capital markets on a scale that could complicate, even limit, the Government's own borrowing strategy. More seriously, the private sponsors' financing could lower the country risk assessment of Indonesia.

> Recommendation: Government review of the finance package must be required to protect the Government's own credit rating and borrowing program.

### c. Raising Local Finance

Should the sponsors be able to borrow or raise equity locally? This question applies primarily to sponsors who are foreign investors. A distinction must be made between local finance raised as bank debt and local finance raised as equity. Local borrowing reduces the foreign exchange risk of the project, and thereby, would also reduce the foreign exchange risk for which the Government would be asked to provide comfort. On the other hand, given the size of some of the potential projects, domestic monetary policy could be thrown off track by significant domestic borrowing for this purpose.

Recommendation: Regarding the sponsor's ability to borrow locally, this is, in part, a macro-economic policy issue and a judgment call on which it is difficult to make a recommendation except in the light of the circumstance of each case. Locally raised equity, on the other hand, can be quite attractive. It not only reduces the foreign exchange risk, but can play a useful role in further strengthening the capital markets. It can also provide an attractive alternative for Indonesian institutional investors such as pension funds, and can be the basis for the development of specialized, energy-targeted mutual funds. Finally, as noted in the previous section, equity enhances the owner's incentives, and locally raised equity may permit a greater share of equity in the project's total capital structure.

### d. PLN Equity Participation

Should PLN participate in the equity? While an equity stake could make the arrangements more transparent to the Government, an equity position will expose PLN and the Government to a wider range of risks than would be the case without equity (see the discussion of the allocation of risk below).

Recommendation: The target should be to avoid equity participation by Governmental entities.

### e. Degree of Government Comfort

What comfort or security package should be provided by the Government? Who should assume the market and foreign exchange risk?

The expected sales revenues will be the major basis for financing the project. Therefore, if sales are to be to PLN, then the project's lenders are going to require a Finance Ministry guarantee or assurance that PLN will be provided with enough resources to meet its obligations. Moreover, to the extent that project borrowings are denominated in foreign currencies and the equity holders desire their return in foreign currencies, significant coverage against foreign exchange fluctuations also will be required.

There are a variety of ways in which foreign exchange risk might be limited. Equity provided in rupiah either by the Indonesian partner, through an issue of shares on the Jakarta Stock Exchange, or through the sale of bonds domestically, could reduce the degree of foreign exchange coverage needed to induce the investment. Ultimately, the foreign exchange content of the project's investment and operating costs will limit the extent of foreign exchange risk cover required. Swaps or countertrade could reduce the risk itself. In the case of countertrade, it would be important that the offsetting exports were really "new" exports if the project is to have the desired additionality characteristic.

> Recommendation: The Government will need to guarantee PLN's performance of its payment obligations under the contract and assume some of the foreign exchange risk if a private project is to be possible. The objective would be to minimize the Government's assumption of exchange risk to that proportion of sales proceeds necessary to service foreign borrowings and the foreign exchange costs of operations. This should be the sole direct assumption of risk by the Government.

### 4. Allocation of Other Project Risks

While financial and operational additionality creates the motive for the Government to pursue the private provision of public services, and an assured revenue stream motivates the interest of sponsors, the allocation of risk between the parties is the heart of the arrangements between the Government and the private sponsors. A mutually beneficial and viable agreement will require, above all, a fair and clear specification of the allocation of each type of risk. A number of other project risks are addressed below.

#### a. Completion and Overrun Risks

Sponsors are likely to ask that the Government assume some of the completion and overrun risks. Some host governments have agreed to this, frequently in the form of standby subordinated loans.

> Recommendation: In Indonesia the Government should be able to avoid this risk. Contractors and sponsors should be able to absorb this risk through turnkey contracts, insurance, etc.

b. Operating Risks

The take-or-pay element in the sales agreement, which will be the basis for the project's finance, will be unenforceable if the stipulated supply is not available. Which party will be looked to by the lenders, and PLN, if the expected output is not available because the plant's equipment does not produce up to the expected capacity, or if the plant is down for maintenance more frequently than planned?

> Recommendation: The capabilities of the plant's equipment should be covered by equipment warranties, insurance, etc. The operator must be responsible for any shortfall in output due to deficiencies in maintenance. There should be not Government exposure on account of operating risks so long as the operator has the required management autonomy.

c. Inflation Risk

Any sale contract is likely to entail some form of price adjustment or escalation clause to protect the sponsors against inflation. That shifts the risk back onto the Government via the comfort that will have been given on the take or pay mechanism.

> Recommendation: The negotiating strategy should be to minimize the scale of price adjustment. From the Government's point of view, it would be desirable to limit adjustment to cover increases in costs, and not to maintain the purchasing power of the sponsor's profit (which is what they will probably ask for). There may be a need to be somewhat accommodating on this last point, but the effort should be to keep any "give" on this to a minimum.

d. Political (Country) Risk

The relevance and measure of political risk is a judgment call that the sponsors must make. Their assessment will, of course, have an important impact on their target rate of return, which will need to cover their perception of risks as well as their required return on capital, and, thus, on the price they ask for their output.

> Recommendation: The Government's negotiators should try to convince the sponsors that this risk is low. Indonesia already has taken all the formal steps usually asked of the sovereign in this regard. It is a signatory to all major bilateral and multilateral agreements and conventions bearing on investment guarantees and protection against nationalization. Moreover, a legitimate and persuasive case

can be made of the facts: twenty-five years of economic, social, and political stability; sustained economic growth; twenty years of full currency convertibility and free capital flows, including capital repatriation and profit transfers; etc.

e. Incentives

Will it be necessary or desirable to offer the sponsors of these projects any incentives additional to those available to regular private investment projects? (e.g., fiscal, land, imports)?

To the extent that these projects can take a conventional investment format, no special incentives, other than those offered all investors, should need to be provided. Tax laws of general applicability and the usual import facilities for new investments should be sufficient. If they are not, and the sponsor claims more is needed, then a question about whether or not the project really generates the desired additionality begins to arise. On the other hand, there should be no administrative road blocks thrown in the way of the project. In addition, it would be fair of the sponsors to seek the Government's good offices in securing a building site, getting licenses, etc.

Recommendation: The target should be to limit incentives to those of general applicability to the maximum extent possible.

5. Other Major Parameters

The following aspects of project evaluation and negotiation raise issues that are sector-specific to a large degree. However, they have broader policy and economic implications. As such, it would be appropriate to include them in general terms in any policy and negotiating framework to be laid down by the Government.

a. Pricing

What basis is to be used for the pricing arrangements ("rate-of-return" or "avoided costs" or PLN's cost of generation)?

Recommendation: The target should be the lowest price for power that is consistent with attracting the desired investment in capacity and motivating the operator to perform efficiently. The most desirable pricing framework or yardstick would seem to be true economic avoided costs. However, every effort should be made to assure that the Government, or the Indonesian consumers, share in any savings that arise because the private operator's costs are lower than avoided costs. In any event, PLN's economic cost of generation adjusted to eliminate the effects of any subsidy PLN may be enjoying should, in general, be the ceiling for the purchase price PLN would pay for power from private generators. Note that the rates that PLN is charging customers is not the relevant benchmark. It is PLN's true economic and financial costs that should be taken as the benchmark.

b. Security of Supply

Is the "take-or-pay" comfort required by the investor to be matched by security of supply comfort to PLN or the consumers?

Recommendation: The Government's negotiators should strongly seek to balance the sales assurances with supply assurances through provisions for penalties (and bonuses). This is equitable and it tends to assure the project's additionality.

c. Fuel and Land

Are these to be supplied to the project by PLN or is the project to procure them directly?

Recommendation: If BOO is the investment format, direct commercial contracting for fuel by the private sponsor is the logical arrangement. Even in the case of a BOT project, direct procurement by the private operating company is a more straightforward arrangement.

d. Training and Technology Transfer

Are these to be specified? Skills and know-how are central to the efficiency argument for private participation. If improved performance is to be built into the system, the skills and know-how must be effectively absorbed by the staff and workforce in Indonesia.

Recommendation: The Implementation Agreement should specifically require training programs and a process of technology transfer, as appropriate. To the extent feasible, the IA should set forth the components of the proposed training and technology transfer.

## VII. THE TELECOMMUNICATIONS SECTOR: CURRENT STATUS

The Government has indicated that after the private power program is up and running, telecommunications will be high on the list of the sectors to which it may turn its attention. The telecommunications sector does exhibit the characteristics that would make it a prime candidate for private participation.

The gap of unfilled demand is proportionately even greater than is the case with power, particularly with respect to the voice subsector of telecommunications. The telephone density in Indonesia is less than one-third that of Thailand. One industry study has estimated that for Indonesia to reach Thailand's current density by the end of the decade will require investments of as much as $4.5 billion in constant 1990 prices, and to catch up with where Thailand is likely to be by the year 2000 would take investments of roughly $6.3 billion.

There is, of course, nothing magical about matching Thailand as an objective *per se*. However, it is said that Thailand's growth, especially in its industrial and service sectors, is now being constrained by its telecommunications bottlenecks. The urgency in filling the gap in Indonesia is reinforced by the extent to which the economy globally is rapidly becoming information and communications driven.

This fact is recognized by the Government, but that recognition is still less sharply focused than in the case of power. Some thinking and discussions are taking place, but it has not yet reached the point of devising a process or mechanism to implement private participation in a coherent or extensive basis. However, the sums involved clearly suggest that the private sector must be a major part of the solution.

The efficiency argument for private participation in telecommunications is strong and persuasive. Changes in market structure have been driven by the dynamics of technological developments to a remarkable extent. This impact of technology makes the nature of the issues in telecommunications quite different from those in the power sector. Thus, while worldwide both the electric power industry and the telecommunications industry are undergoing a process of "unbundling," there is a difference in the causes and nature of this process in the two sectors.

In power, the motivating factor is primarily financing considerations. Independent private power generators are doing essentially the same thing by the same process as the utility would otherwise be doing. Access to finance, balance sheet, tax, and other considerations provide a reason to do it via an unrelated entity. As we have already discussed above, where the basic utility company is state owned, there can be, in addition, managerial efficiency or ideological reasons to unbundle the electric power utility.

In telecommunications, on the other hand, there are very rapid technological changes that in turn have led to a proliferation of new types of services offered and demanded by the customer. In understanding the industry, the distinction between basic value-added services is increasingly important. The competitiveness or comparative advantage of the traditional basic network company in implementing technical change or in providing new and unfamiliar services (EM and FAX replacing telex replacing telegrams, etc.) is gr...ing. Concurrently, barriers to entry have fallen and the unit costs per bit transmitted, both voice and data, has fallen sharply, both absolutely and relative to cost trends in other countries. This makes the opening up of the telecommunications sector to the participation of multiple parties, and in particular private parties, especially logical and compelling. No single telecommunications entity can provide efficiently all the services demanded by customers.

All of these developments bring a policy imperative to bear in support of the need to diversify the providers of telecommunications services. Perumtel has taken the first, but as yet very tentative steps, in this direction. It has embarked on a limited program of private participation in the form of Revenue Sharing Arrangements (RSAs). Those RSAs concluded to date represent a very limited private participation both as to character and scale. They essentially represent a form of financing for Perumtel acquisition of capacity closer in nature to a leasing arrangement than a BOT, let alone a BOO format. The basic conclusion is that private participation in the Indonesian telecommunications sector is a program waiting to happen.

Nevertheless, there is widespread recognition among the top policy makers that serious potential bottlenecks in the telecommunications sector threaten to constrain economic activity. There also seems to be a general recognition in the top ranks of Government that the scale of effort and finance that will be required to avoid capacity shortfalls in telecommnunications sector makes it very desirable--indeed, necessary--to enlist a growing participation by the private sector in this area. So, while the telecommunications sector program is waiting to happen, a consensus on the need for private participation appears to be emerging, which could in turn lead to the definition of the objectives and policy framework within the program would be carried out.

## VIII. TECHNICAL ASSISTANCE REQUIREMENTS

### A. Factors Shaping the Nature of GOI Technical Assistance Requirements

There are a number of factors and conclusions drawn from experience to date that shape the appropriate definition for further policy and technical assistance to the Government:

- The Government continues to have a significant--and growing--interest in and commitment to securing private participation in the provision of public services
- A lack of consensus at the top level of Government on what the objectives are and how they should be achieved remains the key, fundamental problem
- Given the size and complexity of carrying out private provision programs, and the types of highly-specialised skills needed, governments can benefit significantly from appropriately-targeted technical assistance inputs across all sectors.
- Government officials have provided initial guidance regarding the types of assistance required in the period immediately ahead.

#### 1. Government Commitment to a Private Provision Program

The process of bringing private participation into the provision of public services has started with the request for proposals for private implementation of Paiton Units 7 & 8, along with a Terms of Reference to guide the potential sponsors as they prepare their responses. This beginning has proven to be not fully satisfactory for reasons suggested below. Nevertheless, there seems to be little doubt that at the top level of Government there is a significant, and growing interest in and commitment to securing private participation in power generation to help break the power supply bottleneck.

In addition, there is widespread recognition among the top policy makers that serious potential bottlenecks in the other infrastructure sectors threaten to constrain economic activity, particularly inadequate capacity in telecommunications, transportation, and urban services. There also seems to be a general recognition in the top ranks of Government that the scale of effort and finance that will be required to avoid these capacity shortfalls makes it very desirable to enlist a growing participation in the private sector in these areas as well.

### 2. Lack of Consensus on Objectives and How to Proceed

The logical sequence for the implementation of policy formation and decision making, as outlined in Chapter IV Section B above, is not being followed. The necessary starting point--a consensus at the top level of Government on what are the objectives and how they should be achieved--has not been put in place. Only after that is done can a policy framework be defined within which the introduction and encouragement of private participation in any sector can take place on a sound and orderly basis. The negotiating parameters for each sector can then be established within the context of that policy framework.

The risks of proceeding before there is a satisfactory consensus on objectives and policy at the top levels of Government is illustrated by a review of the Paiton Terms of Reference (TOR). A number of quite important economic, financial, and legal issues are omitted or not addressed adequately in that document (see Attachment 5). As a result, the response to the request for proposals based on those TOR was unsatisfactory: the most experienced of the two recipients withdrew partly because of the ambiguous guidance the TOR as drafted provided to potential investors; the commitment bond filed by the other recipient was found to be unresponsive to what was expected by the Private Power Committee. Thus the process is back to square one.

To avoid further delays and aborted outcomes there needs to be a concise, clear consensus on objectives, following from which the selection criteria can be defined, reflecting both the general and sector-specific considerations; proposal evaluation measures can be formulated; negotiating instructions issued; and various aspects relating to implementation can be addressed. To proceed otherwise runs serious risk of unsatisfactory results. Once the foundations are laid along these lines, desirable projects need to be identified. Potential sponsors could be pre-qualified. Terms of reference and requests for proposals will need to be drafted. Complicated financial arrangements will need to be evaluated. Standard contracts must be drafted and continuously refined. Negotiations that could be long, complicated and potentially contentious must be skillfully implemented.

### 3. The Utility of Technical Assistance Inputs

Defining and implementing the Government's program of private participation requires expert financial, economic, commercial, technical and legal skills. Much of this body of skills can be mobilized from within the Government and the sector. However, at key points it will be necessary to supplement this with technical assistance inputs. In fact, given the size and complexity of the task at hand, it is reasonable to assume that the Government could benefit from significant and varied types of technical assistance across all sectors, some of which may need to be sustained over a relatively long period of time.

### 4. Government Guidance on Near-Term Assistance Needs

Government officials have offered the following guidance to shape the appropriate definition for further assistance:

(1) Additional policy-level assistance is required to assist the Government with the analyses necessary to support the further development of an overall policy framework and broad negotiating instructions applicable to all sectors.

(2) There is an immediate need for assistance in the power sector. Prior to proceeding with additional private power bids, an interim period is required to more fully establish a policy and procedural framework to more effectively guide the project selection and negotiating process.

(3) Assistance in other sectors, including telecommunications, transportation, and possibly urban services, should also be made readily accessible to the Government to be utilized on an as-needed basis.

In the power sector, during this interim period mentioned in (2) above, assistance is required on an urgent basis from various specialists to support and facilitate a policy decision-making process leading to the development of a standard Implementation Agreement (IA) and Power Purchase Agreement (PPA). Once these basic documents are in place, embodying the consensus and multiplicity of policy decisions required by the Government in arriving at the various terms and conditions contained in these agreements, institutional issues can be more readily addressed, and standard terms of reference can be developed. Specialists are required in policy analysis, finance, private power business and economics and, toward the end of process, legal matters.

## B. Suggested Technical Assistance Action Program

A review of the factors shaping the appropriate definition of further technical assistance suggests mounting a two-stage effort, described below.

### 1. Phase I: Near-Term Assistance

A six-month period during which the emphasis is on supporting the definition of the objectives and the alternatives facing the policy makers in the overall private provision program. This phase could be made up of three components:

#### a. Assistance Components

(1) Overall Policy Framework: Additional policy-level assistance to support and facilitate the Government's efforts in formulating a policy framework and broad negotiating instructions applicable to all sectors. The objective is to assist, as appropriate, in the analyses necessary to support the process of obtaining a consensus in the definition of program objectives, the definition of an acceptable security package, and the specification of laws and regulations of general applicability under the program.

(2) Private Power: Assistance to meet the specific needs of the private power program during the upcoming interim period as envisioned by the Government, resulting in standard implementation and power purchase agreements (as discussed above).

(3) Other Sectors: Assistance to support the Government's efforts in defining industry-specific programs in sectors other than power. The objective is to provide the Government with inputs that provide a basis for preparing statements containing the role expected of the private sector in providing services, as well as the Government's objectives, policy framework and negotiating parameters.

#### b. Specialist Categories and Estimated Level of Effort

The categories of specialists required during this six-month period, including preliminary level of effort estimates (stated in months), to carry out the three components listed above, include the following:

| | Cmpnt 1 | Cmpnt 2 | Cmpnt 3 |
|---|---|---|---|
| | Policy Frame | Power Sector | Other Sectors |
| Team Leader/Policy Advisor | 2 | 2 | 2 |
| Utility Industry Specialist(s) | 2 | | 2 |
| Private Power Industry Spec. | 2 | 2 | |
| Private Power Economist | | 2 | |
| Finance Specialist(s) | 2 | 3 | 2 |
| Legal Counsel | | 1 | |

### 2. Phase II: Long-Term Assistance

In carrying out Phase I, it should be possible to assess on a firmer basis the scale of the continuing effort, and the specialist needs required. It is anticipated, however, that Phase II could entail adding up to two additional resident consultants--a broad-gauged public utilities development advisor and a finance specialist--to provide assistance on an ongoing basis across the entire spectrum of policy and implementation related matters that the Government will confront in carrying out a private provision program in the years ahead, including:

- Clarifying issues and alternatives as the Government continuously refines its objectives
- Advising on the design and development of implementing procedures and processes
- Analyzing the determinants of additionality in both financial and the efficiency terms
- Defining selection criteria for projects, sponsors and investors reflecting both general and sector-specific considerations
- Formulating proposal evaluation measures
- Developing negotiating instructions
- Pre-qualifying potential sponsors
- Drafting terms of reference and requests for proposals
- Evaluating complex financial arrangements
- Drafting and continuously refining standard contracts

- Assisting in negotiations which are oftentimes long, complicated and potentially contentious.

These resident specialists could be supplemented by the inputs of short-term specialists on an as-needed basis.

## C. USAID-Financed Assistance

USAID/Indonesia, in view of the potentially significant developmental benefits of private participation to Indonesia's economy, strongly supports the Government's emerging policy in this area and is prepared to provide additional policy and technical assistance upon request. USAID is well positioned and equipped to make a unique contribution through the provision of additional assistance, both short and long term, and has indicated that it wishes to remain as responsive as possible to Government requests for assistance.

# LIST OF ATTACHMENTS

# THE PRIVATE PROVISION OF PUBLIC SERVICES: A SUGGESTED NEGOTCIATING FRAMEWORK.

## Introduction

This paper brings together in a concise form the suggested negotiating instructions that are implicit in the Concept Paper. Like all such instructions, they represent negotiating objectives of general applicability to be sought by the Government's negotiators. Good results require that such instructions not be ignored, but the right outcome also requires flexibility. All points in a set of instructions are desirable to achieve, only a few are non-negotiable.

## THE NEGOTIATING PROCESS.

Identify specific projects that will fill critical public service needs.

Prepare tender documents that clearly specify
- (a) the scope of the desired project; and
- (b) any terms or conditions that the Government will require or seek in the final agreements.

> NOTE: In any negotiation it is always better to negotiate from drafts that you, not the other party, has prepared.

Solicit proposals in response to the tender documents (or Request for Proposal documents) from a short list of pre-qualified potential project sponsors who have expressed an interest.

Negotiate with the respondent whose proposal promises the least cost for the services desired.

THE NEGOTIATING FRAMEWORK.

Review of the proposed project financing:

a requirement that the Government must review both the structure and timing of the project's bank borrowing should be non-negotiable.

The project's capital structure:

A minimum equity share in the project's capital structure should be required to assure to assure the sponsor's commitment.

Government equity participation:

Equity Participation by the Government will be precluded. This should be non-negotiable. Equity participation by government-owned entities should be avoided to the maximum extent possible.

Government comfort or guarantees:

The Government's comfort will consist primarily of assurance that the purchase commitments of Government owned entities can and will be honored.

Assurances that present policy on convertibility and transferability will continue to apply to the project for the life of the project could be given.

Assurances that the tax rate upon which the sponsor has made his investment calculations will continue to apply is best made indirectly through the price adjustment process rather than through an explicit commitment that could result in a proliferation of tax rates in the future.

The Government will not guarantee rates of return. This is non-negotiable.

The corporate format:

The Build, Operate, and Own (BOO) format should be preferred over the Build, Operate, and Transfer (BOT) format.

The price of the services:

The full cost at which the services could otherwise be provided generally should be the



54

ceiling for the price to be paid by a public entity for purchase of the services.

Price adjustment or escalation:

The target should be to hold any escalation as close to actual cost increases as possible. The proposition that the real value of equity returns should be fully protected should be rejected.

The allocation of risk:

The allocation of each major category of risk should be explicitly defined and specified.

The Government should avoid assuming any completion risk.

The Government should rule out any responsibility for operating risk except to the extent that government actions impact operations. In return for operating and managerial autonomy the investor should assume full responsibility. This should be non-negotiable.

Investment incentives:

Incentives should be limited to those available to any approved investment.

However, freedom from all administrative interference on procurement, construction, and operations should be assured to the project sponsors, and reasonable use of Government "good offices" to expedite the project should be offered.

Health, labor, and environmental laws of general applicability should apply.

Security of supply:

The "take or pay" commitment of the purchaser should be matched with supply assurances entailing penalties for performance below contract levels.

Training and transfer of technology:

The agreements should explicitly provide for adequate levels of training and technology transfer.

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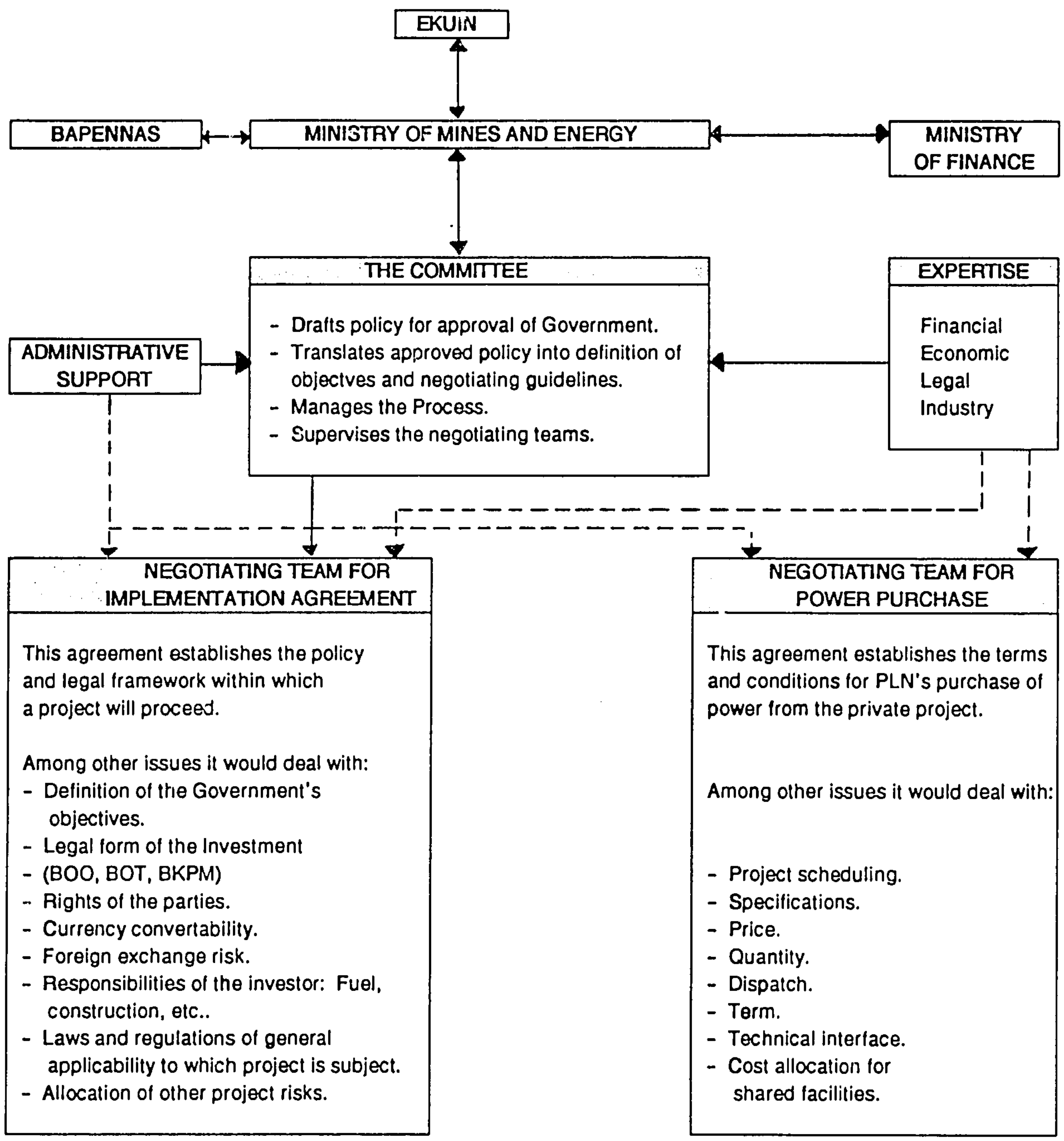
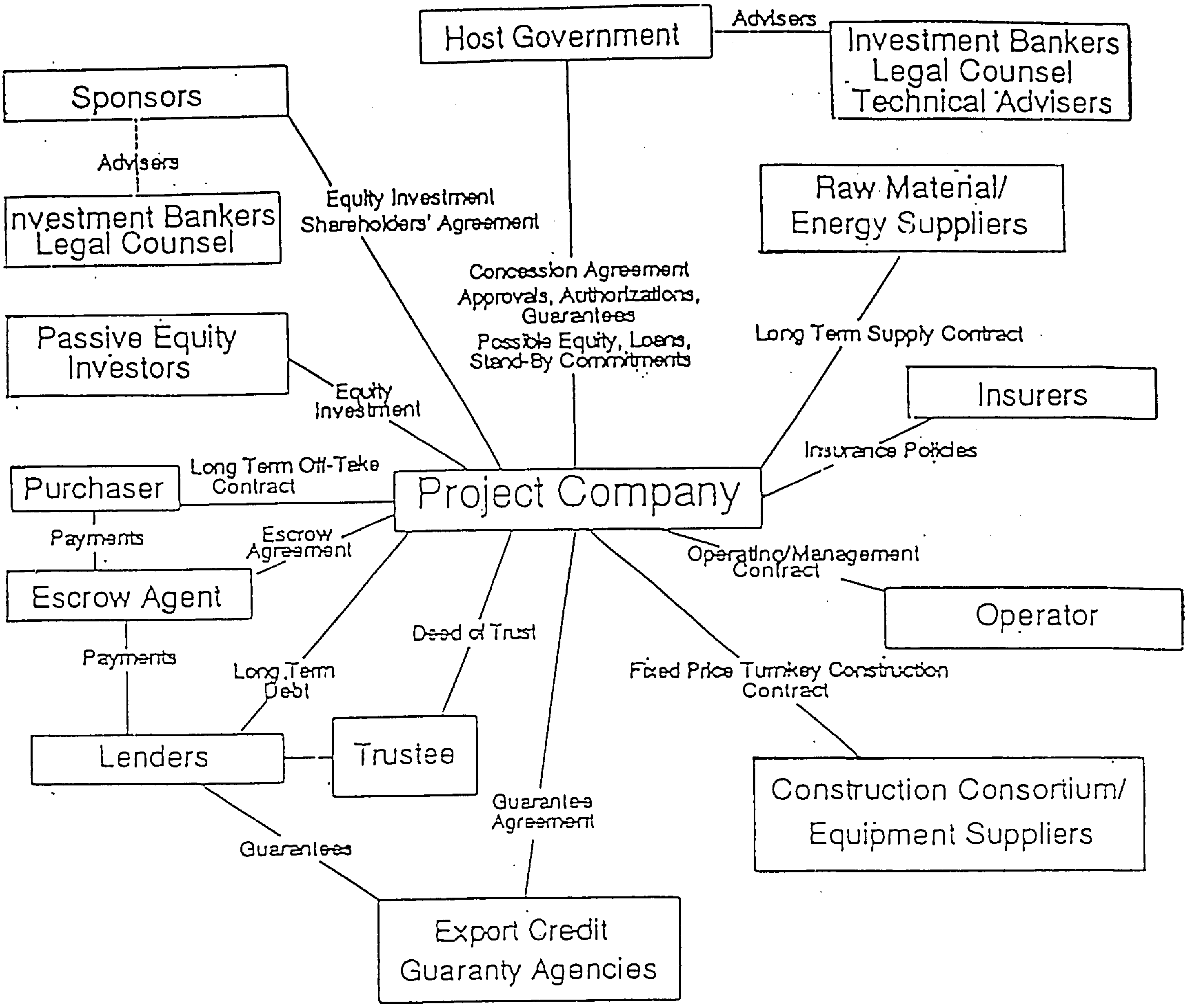
55

**NOTE:** There are a number of ways in which the implementing machinery can be organized. The following schema is suggested for implementing private power in the Indonesian context.

# PRIVATE POWER DEVELOPMENT



# BOT PROJECT STRUCTURE




Note: This is a typical BOT structure as it has evolved in practice up to now. Most applications of the concept have been in situations (P.T.O) where financial and market risks were probably higher than in Indonesia. Therefore, the structure of a BOT project in Indonesia can be expected to be somewhat simpler, but it will still be very complicated.

# INDEPENDENT POWER PRODUCER CONTRACT STRUCTURE

The following sets out the typical structure of contracts associated with a privately sponsored project to generate electric power. Experience to date has involved mainly the BOT investment format. This approach has been developed and applied up to now in economies that have had little or no access to foreign financing for the projects. This, of course, is not the case with Indonesia.

The Government would have little difficulty in borrowing on a sovereign basis for any one major project. A financing constraint arise for Indonesia because of the extent of the investment required to adequately meet the growing demand for public services. Obviously, because the "next" or marginal, project is not the problem, Indonesia's negotiating position is greatly strengthened. Several aspects of the following corpus of contracts might not be relevant here, and other aspects would need to be modified to fit the Indonesian situation.

## I. GOVERNMENT REQUIREMENTS FOR FINANCING REVIEW

- Example: In Pakistan it is a requirement that finance be raised from both local and foreign sources on the basis of an overall 75/25 Debt/Equity ratio.

- Need a blend of off-shore and on-shore financing.

- The financial terms of the project need to include a Project Life Loan Cover Factor for total debt and for Senior Debt.

- In Indonesia this review is needed mainly to assure an orderly relationship to the Governments own international financing program and to monitor the over foreign debt situation of the economy.

## II. THE STRUCTURE OF CONTRACTS

A. <u>An Implementation Agreement</u> -- Which would be entered into by the Government, or a Government entity (in Indonesia's casely PLN), to establish the timetable and framework for implementing the project. Also, need to determine the nature and extent of the obligations and undertakings of both parties, such as:

- Will free remittance of interest, dividends and repayment of principal and capital be guaranteed. (Not a problem under Indonesia's cuvorent policy).

- Does the Government guarantee full loan repayment and investor compensation in the event of transfer of the Plant to the Government.

- Are rights for use and access to Government lands provided for.

- Is foreign exchange convertibility and availability defined and well structured.

- What guarantees have been given by the Government relative to performance of the public sector entities under the Security Package.

- Is there a provision for funding to cover cash shortfalls arising from uninsured events of Force Majeure and disputes.

- Does a guarantee exist relative to non-interference and with non-expropriation of Project assets. (Again not a problem under present Indonesia Policy).

B. <u>Power Purchase Agreement</u>

- Needs to cover the terms and conditions of the sale of energy.

- Is the minimum level of energy to be delivered in order to provide for full payment of fixed costs (e.g., debt service, return on equity and return of capital) reasonable. The "take or pay" or "pay if tendered" principle.

- For capacity that is either higher or lower than the minimum are bonuses and penalties, as appropriate, provided for.

- Does the agreement include provisions to adjust the tariff in line with changes in input costs (e.g., inflation and exchange rate indices that take account of cost increases outside the Project Company's control, such as changes in the price of fuel oil).

- Does the agreement provide for tariff reopeners.

- Does the Government guarantee the performance of the purchasing utility or group of customers.

C. Construction Contract

- Are the terms well specified (e.g., fixed price, indices driven, etc.)

- Does it include guarantees of completion, net plant generating capacity, fuel consumption efficiency and an minimum of a one year warranty of plant performance.

- Does it provide for liquidated damages for certain defined events of default, including late completion of the plant.

- Are provisions which will allow for the monitoring of the contractors performance and quality of work provided for.

D. Fuel Supply Agreement

- What type of contract is it (e.g., indices driven, fixed cost plus profit, etc.)

- Do penalties exist for failure to deliver.

- Does the contract provide for quality of fuel assurances.

- Are minimum and maximum quantities of fuel deliveries defined.

- Is the performance guaranteed by the Government.

- Does the agreement provide for price adjustment reopeners.

E. Operating and Maintenance Agreement

- Operator selection criteria should include, but not be limited to:

    - International reputation (proven operating track record).

- Proven ability in the operation, maintenance and management of the specific type of power plant installation.

- Relevant overseas experience.

- Willingness to enter into long-term agreement, incorporating appropriate guarantees, penalties and rewards.

- Readiness to participate in the Project development costs and in the Project Company's equity (a very important issue); and

- Readiness to assist in negotiations of the Fuel Supply Agreement and in other relevant activities within the Development Phase.

- Are budget procedures spelled out (operating and capital projects).

- Is a detailed plan of the plants load cycle required.

- How do the operation and maintenance cost terms and conditions relate to the terms and conditions of the tariff included in the Power Purchase Agreement.

- Is a balance of risk to protect against cost variations outside of the operators reasonable control, included in the agreement.

- Are the indices which will drive the costs well defined.

- Does the agreement specify that the plant will be operated in accordance with all applicable laws, standards, regulations (e.g., concerning safety and the environment, etc.).

- Does it include a well defined section concerning the administration and management of the Power Purchase and Fuel Supply Agreements.

- Does the agreement include a guarantee on performance with respect to the operators responsibilities.

- Does the agreement incorporate a reward for efficiency performance program.
- Does the agreement align with the other agreements in the package.

## Terms of Reference for the Paiton Private Power Project:

### Comments

There are a number of modifications to the Terms of Reference (TOR) as it now stands that would be desirable to make because they would: (a) more effectively secure the interests of the Government (GOI); (b) strengthen the hand of the Indonesian negotiators; or (c) make the negotiating process smoother.

It is understood that the TOR has already gone out to the sponsors selected to make proposals for Paiton units 7 & 8, the Roy Family Group and the Hopewell/Bimentara consortium (who have since withdrawn). Therefore, in the context of that project the present TOR draft has official standing. In that circumstance the present suggestions could be considered a basis for strengthening and refining the TOR for its use in future cases. However, at the time, the comments provide points that should be raised by the Indonesian negotiators when further discussions with Roy take place..

Changes that could protect the Government's interests and strengthen the hands of the negotiators.

The TOR has three main shortcomings in this respect:

1. The determinants and limits of an acceptable price are not defined.

2. The TOR is not clear and specific on the limits to acceptable recourse

3. There are a number of statements in the Commercial and Financial sections of the TOR that could be read as implying more Government support and guarantee, and hence a more riskless prospect for the sponsor, than the Committee probably intended.

Recommendations:

Pricing Criteria.

The TOR should set forth a clear and specific statement of the parameters within which an acceptable price would need to fall. This is necessary in order to have clear negotiating instructions and, also, to assure

63

that the outcome protects the Government's interests and achieves the Government's goals,

In general terms this could be stated, for example, as "the proposed price(s) must be below [or "equal to or below"] the avoided costs that the project makes possible" If desired, it could be stated in more concrete terms as "the price must not exceed PLN's cost of generation [either at the site or system wide]". Note that while Article 5.2, "Proposal Evaluation Criteria" does state that price criteria will be used, it says nothing at all as to what those price criteria will be.

This does not mean that the TOR should state what "the" price would be. That would be counterproductive since the objective should be through negotiations to get the electricity on the best price terms consistent with getting the supply of power that is desired.

Defining the price criteria explicitly in the TOR does two things: It gives the sponsor a concrete benchmark against which to conduct his financial analysis and prepare his feasibility study. That, in turn, saves the sponsor time and effort and precludes long and sometimes heated negotiations on a proposal that is inherently unacceptable to Government.

Minimizing Recourse.

Clearly it will be important to the Government to limit recourse to the maximum extent possible. Article 4.6.4 does say that "All project financing shall be raised without direct G.O.I guarantees of repayment. Return on investment shall not be guaranteed by the G.O.I."

The use of the word "direct" in the first sentence is unfortunate in its connotations and should be deleted from any future TORS. The second sentence, the rejection of profit guarantees, is excellent and essential.

However, that single reference to guarantees is open to misinterpretation when read in conjunction with other articles in the TOR, especially the sentences in Article 4.5.1 which reads "The proposed price of electricity shall consist of three components: 1. Capacity; 2. Energy; and 3 Performance. Capacity payment shall include all fixed costs, i.e. capital costs, fixed operating costs, profit. Energy payment shall include all variable costs, i.e. variable operating costs, fuel cost.", and when read in conjunction with the preceding sentence in Article 4.5.1.

64

Presumably, the assumption is that capital and other costs will be negotiated and agreed between the parties, and that, therefore, these payment components will be limited by the agreed and negotiated cost and will be based on audited numbers. However, that is not said. The present text could be read as to say that "costs" are what the sponsor says they are. The TOR should make clear that was not the intention.. This is particularly bothersome in the absence both of price ceilings and of the government' willingness to guarantee PLN's performance of commercial obligations under the agreements.

Recommendation.

The word "direct" should be deleted from Article 4.6.4. The TOR should go on to state clearly its position on avoiding or minimizing its sharing in any of the other project risks (completion, cash deficiency, operations, etc.)

The absence of explicit pricing parameters and the vagueness of the treatment of recourse are examples of aspects of the TOR that may seem to potential sponsors to promise more than was intended. Vagueness as to the basis upon which discussions will proceed makes the job of the Government's negotiators more difficult. Issues that should have been foreclosed in the TOR would now need to be dealt with in the negotiations themselves.

<u>Implications of other aspects of the TOR for the Negotiating Process.</u>

There are several features of the Terms of Reference that could have an adverse effect on the Team's negotiating strength or effectiveness. Among these are:

1. The absence of an explicit statement to the effect that "The Government reserves the right to reject any or all proposals it may receive."

It may have been assumed that this went without saying since that is an inherent right of a sovereign government. In a sense that is true, of course. However, the lack of an explicit statement, which the Government frequently has put into its requests for proposals, can result in a controversy with a potential sponsor.

That is because the requirement of a commitment bond prior to the preparation of a feasibility study and project proposal, which can be an expensive process for the sponsor, gives him a right to expect that the Committee will go to negotiations on any proposal he submits by the deadline, even if the Committee finds the proposal unacceptable on its face. The Committee, of course, would prevail in any argument over this issue, but it why not avoid the basis for the argument. This is even more likely to be troublesome when there is only one sponsor preparing a proposal, as is currently the case for the Paiton project.

2. The TOR calls for the private sponsor to prepare the draft agreements that will form the basis of the negotiations.

The proposed procedure enables the sponsor to make the first statement of the Government's proposed obligations! This is something the Government should prefer to do for itself. **In any negotiation it is always better to be negotiating from your own draft rather than on the basis of a draft prepared by the other party.** This has been the Government's experience with many categories of negotiations. Due to time pressures it may not have been possible in this case to prepare these drafts before sending out the TOR for the Paiton project. Nevertheless it should desirably become standard operating procedure for the Private Power Committee.

Recommendation:

The Committee should have the model contracts drafted as rapidly as possible. These drafts should reflect the thinking of the Indonesian authorities. It would be very desirable to have them ready to accompany any further requests for proposals. It would also strengthen the hand of the Committee to have their drafts ready to table as an alternative to the sponsor's draft when the negotiations for the Paiton project start. The Government's lawyers, White and Case, could facilitate speedy implementation of this process.

The Financial and Commercial Terms

The TOR clauses dealing with the financial and commercial aspects of the feasibility study and implementation proposals, pages 16 - 18, are too brief and too narrow in their coverage. They run the risk, on the one hand, of seeming to promise the sponsor a more riskless project with less constraints on costs than is the intention of the Committee, and, on the other hand, of giving the sponsor too little guidance as to the parameters within which the Government would expect costs and prices to fall.



66

**Miscellaneous Comments.**

The sequence in which to execute the documents.

In the definition of Implementation Agreement (IA) it is stated: "All other Agreements in the Security Package must be executed prior to the execution of the IA (page 7). This is not a usual or logical way to proceed. Normally all the security package documents are attached in agreed draft to the IA and signed simultaneously.

Recommendation.

Delete this requirement for prior execution from the definition of the Implementation Agreement and follow the more usual procedure of concurrent signature of the Implementation and other security package documents.

Equity requirements.

The TOR as issued is silent on the question of equity. I understand that there was a minimum equity requirement stated in an earlier draft of the TOR. While it does not make sense to stipulate a specific requirement - there is nothing magic about a given debt/equity ratio such as 70/30 as against, say, 75/25 - equity is an important consideration. Equity is desirable for a number of reasons:

real equity (the sponsor's money at risk) creates a strong incentive towards efficiency and cost consciousness and is a measure of the sponsors long term commitment to the project;

equity is that part of total project finance that creates a contingent servicing requirement, not a fixed requirement - dividends are paid only if the operations successfully generate a profit, debt must be serviced even if there is a loss;

equity can have a favorable impact (for the Government) to the extent that interest is deductible, but dividends are not, for corporate tax purposes

Recommendation.

Add a sentence to the TOR to effect that:

"While a specific minimum equity/debt ratio is not specified as required, the Government favors a strong equity commitment by the sponsor to the project. The role of equity in the proposed financial package will



61

be a major evaluation criteria as the Proposal is reviewed."

The sponsor's lenders, of course, will themselves require a provision of equity to increase the prospects of successful servicing of their loans to him, but the Government has a wider set of interests in the presence of substantial equity and should so indicate in the TOR.

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