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# PURSE PROJECT

*Private Participation in Urban Services*

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## PURSE ROUNDTABLE DISCUSSION PAPERS

PURSE Report No 3 03 5 94/008

*Submitted by*  
Chemonics International  
Jakarta Indonesia

*In association with*  
Resource Management International  
Sheladia Associates

February 1994

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BAPPENAS  
DEPARTEMEN DALAM NEGERI

DEPARTEMEN KEUANGAN  
DEP PEKERJAAN UMUM

# **PURSE ROUNDTABLE DISCUSSION PAPERS**

**PURSE Report No 3 03 5 94/008**

**February 1994**

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# **EXECUTIVE SUMMARY**

# Executive Summary

The PURSE Project, sponsored by the National Development Planning Agency (Bappenas), Ministry of Finance, Ministry of Home Affairs and Ministry of Public Works, of the Government of Indonesia and United States Agency for International Development (USAID), held a Round Table Seminar on 8 February 1994, at the Borobudur Hotel in Jakarta

The propose of the seminar was to permit central government officials for the four GOI ministries which work with PURSE Project, together with officials from USAID and private sector representatives persons, to discuss private participation in urban services

This report provide transcripts of the six discussion papers presented at the seminar, as well as the agenda for the seminar, and a list of the seminar participants

There were three papers presented in the morning program, with extensive roundtable discussion by participants following each presentation

The first discussion paper presented was "Opening Remarks on Private Sector Participation in Urban Services" by Dr Budhy Tjahjati S Soegijoko

The second was "Major Issues for Developing Public Private Partnerships and Future Directions of the PURSE Project" presented by Mr C Mark Williams, Chief of Party of the PURSE Project

The third was "Issues Impacting Upon the Policy Framework for Participation of the Private Sector in the Provision of Urban Services" presented by Mr Anthony Torrens, Urban Economics Advisor of the PURSE Project

In the afternoon program, three private sector speakers representing the lending, community and legal services from Hong Kong presented papers outlining their perspectives on financing and structuring Public Private Partnerships

The fourth discussion paper presented was "A Discussion of Key Issues for Financing Infrastructure in Indonesia" by Mr Paul D Fyke of the Chase Investment Bank, Hong Kong

The fifth was "Financing Models for Environmental Infrastructure" presented by Mr Jean-Jacques Poirrier of the Chase Investment Bank, Singapore

The last discussion paper presented was "PPP/PSP Legal Issues and Institutional Mechanisms that Facilitate Development of Infrastructure using Public-Private Partnerships" by Mr Raymond W Vickers of Skadden, Arps, Slate, Meagher & Flom, Hong Kong

# PAPER I

# **Private Participation in Urban Services Project**

## **PURSE ROUND TABLE SEMINAR**

### **Opening Remarks**

Prepared by

**Dr Ir Budhy Tjahjati S Soegijoko, MCP**  
Head  
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BAPPENAS

The PURSE Project is sponsored by

### **Government of Indonesia**

**National Development Planning Agency (BAPPENAS)**  
Ministry of Finance  
Ministry of Home Affairs  
Ministry of Public Works

&

### **United States Agency for International Development**

Office of Private Enterprise Development

8 February 1994

## OPENING REMARKS

Good morning ladies and gentlemen

It is a great pleasure for me to be here with you today I would like to welcome you all to the first seminar being held by the PURSE Project

The attendees at the seminar this morning include senior representatives from each of the four ministries which oversee the activities of PURSE BAPPENAS, the Ministry of Home Affairs, the Ministry of Public Works, and the Ministry of Finance In addition, we have with us a group of senior regional officials, and representatives of the US Agency for International Development, the American Chamber of Commerce, and the private sector

The seminar is being sponsored jointly by the Government of Indonesia and USAID

The purpose of the seminar is to create a forum for the PURSE Project where central government (Pusat) officials and private sector representatives can discuss ways to structure private sector participation and public-private partnerships in urban infrastructure, and can provide regional (Tk I) officials a thorough understanding of how to undertake private sector participation and public-private partnerships in urban infrastructure projects

The seminar will be an open roundtable discussion We are hoping for active participation by everyone present, and would urge attendees to share their comments on issues, so that we can define ways to structure private involvement in urban infrastructure, and can set out an agenda for future PURSE Project activities

Today's agenda has been described by the moderator So let us proceed to the business at hand - discussing ways to structure private sector participation and public-private partnerships in basic urban infrastructure services in the water, wastewater, and solid waste sectors

I would like to use these opening remarks to identify some of the topics we may discuss today, by presenting a brief overview of some of the major issues related to private sector participation and public-private partnerships in urban infrastructure in Indonesia, and by outlining the role of PURSE Project in this context

## **I Overview of Issues Private Sector Participation and Public-Private Partnerships in Urban Infrastructure**

Indonesia is rapidly becoming an urban nation. The results of the 1990 census indicate an average annual rate of growth of the total urban population of 5.4 percent between 1980 and 1990. Larger cities with populations of 200,000 to 2.5 million (excluding Jakarta) are growing from 3 percent to over 6 percent annually. Smaller cities are growing even faster.

If the 5.4 percent annual urban growth rate is sustained, the urban population could be approximately 84 million in 1998 - only four years from now. At the present rate of growth, approximately 3,300,000 people (equivalent to a city larger than Surabaya, or six cities the size of Padang) are being added to the urban population every year. And that number is increasing each year. It has been projected that over half of the population of Indonesia could be urban early in the twenty-first century - perhaps by 2008.

The potential contribution of urban development to the Nation's overall development clearly is great. Economic growth in real terms since 1984/85 has been between 4.5 percent (1984/1985) and 7.5 percent (1989/1990). The growth in manufacturing, which typically is urban based, has been much higher (12.7 percent in 1984/1985). Urban output now constitutes somewhere between 40 and 50 percent of GDP (between 50 and 60 percent if oil and gas are excluded). Most of the activities contributing to the Government's program of economic diversification require urban locations.

However, the realization of that potential will depend, in particular, upon effective urban management - to provide the infrastructure, public facilities and services needed, and to facilitate the involvement of private entrepreneurship and community initiatives essential for successful development.

Without sound urban management, the economic, social and environmental costs of rapid urbanization are likely to be very high - and recovery from the damage done is likely to be long and difficult, as the experience of other countries has shown.

The Government has demonstrated a sustained concern with major components of urban development in its national planning since the first Repelita. Urban development is expected to play an important role in the evolving program of governmental decentralization, as well as economic diversification. Impressive progress has been made already in urban development - in increasing institutional capacity, in constructing

physical improvements, and in providing financing for urban growth

One of the most crucial elements of urban growth, and the focus of the PURSE Project, is the provision of basic infrastructure - water supplies, wastewater treatment, solid waste management, road systems, electrical power, and telecommunications. There are still significant deficiencies in this regard - in the performance of local government functions and in the efficiency of financing mechanisms - which are hindering the development of adequate urban infrastructure.

There are four issues which significantly impact the delivery of urban infrastructure facilities and services, and which fall within the scope of the PURSE Project's agenda for discussion today. These are (1) the legal and regulatory framework, (2) institutional and management capacity, (3) the role of private sector resources, and (4) mobilization of domestic savings for investments in urban infrastructure.

## **1 The Legal and Regulatory Framework**

- Clarification of the legal and regulatory roles and responsibilities among the levels of government and within each level of government is needed, as are improved coordination - within individual agencies, within each level of government, and among levels of governments.
- Streamlining the regulatory apparatus - particularly at the regional and local levels - to encourage efficiency, and facilitate private sector involvement in infrastructure development, would assist in the development of infrastructure.
- The formulation and application of detailed administrative regulations and guidelines regarding private sector participation in urban infrastructure are needed to interpret recent legislation.

## **2 Institutional and Management Capacity**

- This is one of the areas of greatest concern. Institutional bottlenecks are at least as much of a problem as financial and other resource bottlenecks. Improvements in organizational structures and management procedures are needed in the key government entities which develop and manage urban infrastructure.

- Decentralization of responsibilities and resources for the development of infrastructure may be helpful, where there is adequate provincial and local government capacity
- Both the Government and external assistance agencies have focused their institutional development activities on improvements needed for better project management. As a result, the importance of strengthening coordinated urban management, particularly at the local level, has been underestimated
- Efficiency is now receiving more attention at all levels of government. Nonetheless, there still is considerable room for improvement - in deciding what and when to invest in new infrastructure facilities, and in ensuring the proper operation and maintenance of both existing and new systems
- Many local governments are managerially and fiscally weak. There still is large dependence on the central government for investment funds and for many development initiatives

### **3 The Roles of Private Sector Resources**

- The roles which private sector resources can fill in relation to urban infrastructure programs at all levels of government - particularly at the regional and local levels - need further clarification. This is what the whole PURSE Project is all about
- The major potential private sector investment partners in infrastructure services and development - private commercial enterprises, banking institutions, and other financial entities such as life insurance companies and pension funds - will have different roles to play. There may be several potential models of private sector participation and public-private partnerships
- The roles of private sector entities in infrastructure may include participation in the establishment of development priorities, direct development for private purposes, and the private provision of public services

#### **4 Mobilization of Domestic Savings for Investments in Urban Infrastructure**

- Because there are not yet adequate mechanisms for the sustained and voluntary mobilization of domestic savings for investment in urban infrastructure, the progress of governmental investment in urban infrastructure is not keeping pace with growth
- Central government subsidies cannot be sustained at levels adequate to finance the infrastructure needed to rectify existing deficits and provide for the very rapid growth that is foreseeable Lending and grant programs from external assistance agencies can meet only a small part of the need for capital
- There is a need for a long-term strategy for mobilizing domestic savings at a sufficient scale for the financing of urban infrastructure, linked to the development of Indonesia's financial system and capital markets
- A long term strategy for establishing the credit-worthiness of local governments, and local or regional government authorities providing infrastructure services, is also needed

#### **II Recent Progress in Private Sector Participation and Public-Private Partnerships in Urban Infrastructure**

For the past several years, the Government has been involved in a broad national agenda of private sector investments in infrastructure, including major programs in toll roads, telecommunications, and power

For municipal infrastructure services, the primary focuses have been on water supply and solid waste management Significant progress has been made in structuring private sector participation and public-private partnerships in both water and solid waste management

I would like to briefly mention some of the more notable trends in private involvement, to suggest some specific topics for discussion today

## **1 Water Supplies**

In some of our larger cities, a portion of the routine repairs, maintenance, and some of the billing and collection services are now being provided by private firms. Both Surabaya and Medan, for example, contract for billing and collections. Surabaya contracts with 15 firms for three month terms, Medan contracts with one firm for a three year term. This has resulted in collections rates of up to 98 percent, and may be a model for PDAMs nationally. Contracting is a trend which is spreading rapidly.

To date, there has been one large scale BOT in water supply. This is the Nusa Dua water supply system, in Bali, where a private consortium and the PDAM have developed an extraction and distribution system for hotels and residential users. The joint venture which was created to manage the development of facilities and ongoing operations has a concession for a period of 20 years in an area of the PDAM district. It is owned 55 percent by three private partners, and 45 percent by the PDAM Badung, with percent ownership based pro rata on the value of equity contributed to the venture.

Several other major public-private water projects are being planned. These large BOT projects have proven to be complex to negotiate. Among the issues encountered are

- How to gradually raise water tariffs to levels which permit enough income to cover development costs without causing social problems,
- How to control project costs, and limit the amount of private capital which is needed,
- How to phase projects based on both demand and project economics, so that the initial phases are feasible from an engineering perspective and financially,
- How to encourage the structuring of low cost private financing without providing general government guarantees

## **2 Solid Waste Management**

An increasing portion of the street cleaning, solid waste collection and disposal, routine repairs, maintenance, and some of the billing and collection services in many cities throughout the Nation are now provided by private firms, and also by community associations which have a long history of involvement in solid waste management.

There is one large BOT project in solid waste - the Cibinong chemical waste facility, in West Java. This project is a central industrial waste treatment facility, which is designed to treat and dispose of hazardous and toxic chemical wastes. It is the first of its kind in Indonesia. The first phase of the facility, which includes a landfill and a stabilization plant for more volatile substances, is recently completed and in initial operations.

### **III The Role of the PURSE Project**

The PURSE Project has a key role in the context of the Government's urban infrastructure programs, particularly in view of the need for continued progress in the area of private sector involvement. There are three principal elements to the PURSE work program:

- Policy, legal, and regulatory review. PURSE will prepare a review of the policy, legal, and regulatory framework regarding private involvement in urban infrastructure in the water, wastewater and solid waste sectors. PURSE will work with the Government in proposing new, modified, and updated laws and regulations for private sector participation and public-private partnerships in the PURSE sectors.
- Demonstration projects. PURSE will work with the Government to structure a series of private sector participation and public-private partnership pilot projects which can serve as models.
- Training. This is a very important area. PURSE will provide continuing training programs, both in Indonesia and overseas in the United States, for government officials and private sector representatives.

### **IV Conclusion**

I am looking forward to today's discussions, which should be an eye opener for all of us. I hope that there will be active participation from everyone around the table, and that we will all come away from the seminar with a clear perspective on the possibilities for private sector involvement in urban infrastructure services.

# PAPER II

**Private Participation in Urban Services Project**

**PURSE ROUND TABLE SEMINAR**

**Major Issues for Developing Public Private Partnerships**

**&**

**Future Directions of the PURSE Project**

**Prepared by**

**C Mark Williams**

**The PURSE Project is sponsored by**

**Government of Indonesia**

**National Development Planning Agency (BAPPENAS)**

**Ministry of Finance**

**Ministry of Home Affairs**

**Ministry of Public Works**

**&**

**United States Agency for International Development**

**Office of Private Enterprise Development**

**February 8, 1994**

## **Introduction**

As Indonesian urban areas expand and economic growth continues at a rapid pace, the need for urban environmental infrastructure in the water, wastewater and solid waste sectors is growing dramatically. Although the Government of Indonesia has invested heavily in the development of urban infrastructure, increasing demand for new infrastructure is overwhelming the productive capacity of traditional governmental mechanisms for building and financing infrastructure.

Economic growth (and new job creation) will be restrained without a satisfactory infrastructure base. Lower economic growth results in the need for government to provide more services to the unemployed and decreases government resources available for investment. Environmental and health consequences which result from deficiencies in the environmental sector can be overwhelming, and the resultant effects of contaminated groundwater and poor air quality impose enormous direct and indirect costs to government and society.

Fortunately, Indonesia is cognizant of the need to upgrade and expand its urban infrastructure and is moving on many fronts to develop systems that will facilitate corrective action. Indonesia is decentralizing central government controls on the development of environmental infrastructure and delegating expanded authority to local government officials to encourage new infrastructure development.

Indonesian government officials have recognized that most local governments do not have the financial resources to build major infrastructure systems (Investment needs are estimated to be \$10B per year well into the twenty-first century). To solve this problem, the GOI is undertaking government reforms that will permit local governments to access capital and technology through involvement with public private partnerships, whereby private business consortiums will contract with local government agencies to finance, build, and operate capital intensive infrastructure projects.

Contracting with private corporate entities through public private partnerships (PPP) to build infrastructure is a complex undertaking in which local governments have little or no previous experience. When public private partnerships are successfully implemented, local governments can achieve enormous benefits including a substantial

improvement to the environmental quality of life. However, there are many risks inherent in this new type of procedure, and when risks are not properly balanced, governments can find themselves burdened with large financial obligations and poorly operating infrastructure.

### **Description of the PURSE Project**

Although many of you in this audience are familiar with the Private Participation in Urban Services Project, I believe that it is appropriate to briefly discuss the major focus and direction of the PURSE initiative. The goal of the PURSE Project is to assist the Government of Indonesia with the development of new legal and administrative mechanisms that will facilitate increased production of urban environmental infrastructure in the water, waste water and solid waste sectors through expanded use of public private partnerships.

The PURSE project team works with representatives from four GOI ministries and has three major project components. These project components are as follows: (1) Legal and Regulatory Component, (2) Demonstration Project Component, and (3) Training and Communications Component. PURSE is a cooperative effort between the Government of Indonesia and the United States Agency for International Development.

### **Legal and Regulatory Component**

The objective of the legal and regulatory component is to assist the GOI in the development of an institutionalized local government process which authorizes local government agencies to develop urban environmental infrastructure by contracting with private sector firms to finance, build and operate public domain infrastructure facilities. The PURSE project will assist the GOI in the development of new laws, decrees, regulations and standard operating procedures which empower local government departments with expanded authority to enter into public private partnership agreements for environmental infrastructure development.

### **Demonstration Project Component**

PURSE also has a mandate to work with central and local government officials to develop demonstration projects where corporate and governmental entities enter into

public private partnership agreements to build infrastructure and/or manage services needed to support infrastructure operations. Demonstration projects can range from bulk water supply projects costing over \$200,000,000 (Rp 420,000,000,000) to management and service contracts which focus on bill collecting, transportation services, maintenance and facility operations (Management and service contracts are referred to as Private Sector Participation or PSP). PURSE project staff will provide the GOI with assistance on technical and financial matters regarding demonstration project development.

### **Training and Communication Component**

Under the PURSE Project, an extensive training and communication program will be developed so that changes to the legal and regulatory framework for public private partnership projects can be disseminated to governmental officials at all levels. In addition, the knowledge and the experiences gained from implementing demonstration projects will be transferred to local governments through various training formats so that local officials learn about public private partnerships from actual experiences. Whenever possible, central and local government officials who have gained expertise and knowledge from actual job experiences will be brought into the training program to provide a more realistic and meaningful training format.

### **PURSE First Year Activities**

Chemonics is pleased with the results of first year of PURSE Project Activities. Although there were a number of difficult start-up problems, much progress has been made with this most complex but important project. We believe that PURSE is now poised to achieve significant progress during the second year of operation, and it is our hope that this progress helps the Government of Indonesia to achieve its goals of developing more urban infrastructure using alternative financing sources through participation in public private partnerships.

It is very important to state here that the achievements of PURSE during its first year reflect the healthy partnership between the Government of Indonesia, the United States Agency for International Development and Chemonics International. Chemonics is pleased with the high level of commitment that the Government of Indonesia has demonstrated in working to achieve the goals of the PURSE initiative. We look

foreword to a continuation of this goodwill, and in return, we offer our commitment to work with you to achieve success in this endeavor

### **PURSE Project Activities Preliminary Conclusions and Future Directions**

Chemonics has focused on five major programmatic areas during the first year of PURSE. I think that it is appropriate to summarize these areas and to discuss some of our major findings as well as recommendations for future project activity and direction. Although our findings are still in a preliminary stage, we feel that the information which we have collected and analyzed thus far permits us to make informed judgments and give thoughtful responses to PURSE issues.

We recommend that the GOI consider focusing on the following issues during the second year of PURSE:

#### **Second Year PURSE Issues**

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- I**      Develop GOI Administrative Guidelines and Procedures for Public Private Partnership (PPP) Projects
- II**     Design a Legal and Regulatory Program which Authorizes Public Private Participation Consistent with both Government and Business Practices
- III**    Develop Standards for Design, Construction and Operations for Sanitary Landfills, Solid Waste Transfer Facilities and Waste Water Treatment and Distribution Systems
- IV**    Develop a Project Risk Management System using Financial and Performance Guarantees for PPP Projects
- V**     Design a Capital Market Financial Instrument (i.e. Revenue Bond) for PPP Projects
- VI**    Develop Financial Models for BOO/BOT Projects

## **I Develop GOI Administrative Guidelines and Procedures for Public Private Partnership (PPP) Projects**

Public Private Partnerships are a relatively new concept for Indonesia. Very few business and governmental officials have direct experience with projects developed through public private partnerships, especially large capital intensive environmental infrastructure projects. Therefore, most business and governmental officials do not know how to proceed in order to begin the process of developing projects using private sector participation. One of the most important tasks for both PURSE and the Government of Indonesia will be the development of administrative mechanisms that provide governmental officials with well defined guidelines for implementing PPP projects.

It will be equally important for business consortiums that are interested in seeking opportunities to develop and/or manage infrastructure services for government to understand government administrative mechanisms for public private partnerships. Business officials need to know the correct agencies and officials to approach for PPP Projects. In addition, businesses also need to understand government procedures and regulations for tendering, contracting, procurement, and, most importantly, tariff structuring.

Government officials need to consider criteria for offering proposed PPP projects to private business groups. There are four principal methods for soliciting private sector interest in public private partnerships projects. They are as follows:

### **Methods for Offering PPP Projects to Private Sector Groups**

- 1 GOI/Local Government Completes Detailed Design of Project and Offers an Open Tender through a Competitive Bidding Process
- 2 GOI/Local Government Completes Conceptual Design of Project and Offers an Open Tender that Requires Interested Parties to Propose a Project Design/Build Scheme through a Competitive Bidding Process
- 3 GOI/Local Government Completes either Conceptual or Detailed Project Design and Approaches a Selected Business Consortium to Propose a Negotiated Project

4 An Interested Business Consortium Prepares a Conceptual Project Design and Approaches the GOI/Local Government to Propose a Negotiated Project. GOI/Local Government Accepts Offer of Negotiated PPP Project

Each of these systems has its advantages and disadvantages. The first concept is designed to focus competitive market forces to maximize *price competition* and lower project costs to the government. This system works well when there are a large number of experienced private firms who are prepared to compete vigorously to be selected for project development.

The second concept is designed to focus competitive market forces in order to maximize *price competition and market innovation*. This method of competition frequently results in a variety of lower cost innovative project designs. When competition from a large number of experienced private firms is keen, this system can produce many viable cost efficient alternatives. Neither of the first two concepts are very effective in a climate where competition is weak and the private sector is inexperienced.

The third and fourth concepts are similar in that they both advocate a negotiated project as opposed to a competitive bidding process. These systems permit both sides to state their clear objectives and work together in a creative manner to design and develop PPP projects. Negotiated transactions can be very beneficial when both parties are experienced with PPP project development and implementation and have the ability to achieve cost effective project designs.

In PPP projects, serious problems can develop quickly if one of the principal parties to a negotiated transaction does not possess the skills and experience needed to design and negotiate viable projects. In addition, inexperienced professionals are usually not able to articulate clear project needs and objectives. These kinds of problems often lead to faulty project designs and result in development agreements which produce unintended project results. Development agreements need to present clear and concise responsibilities and detailed scopes of work for well thought out projects for each of the principals of the project.

The government needs to assess its strengths and weaknesses prior to proceeding with PPP development and implementation. Inexperienced GOI officials should not hesitate to seek outside resource persons who possess the knowledge and experience to

negotiate PPP projects. Although legal, financial and engineering consultants can be costly, the cost of project failures can be far more expensive in the long run. Government officials, with their limited knowledge of the private sector, cannot expect to negotiate agreements on par with experienced business professionals and should not hesitate to use resources which give them a competitive balance or even a competitive advantage in a negotiation process. More importantly, government officials need to work hard at selecting business partners and/or project developers that have a reputation for integrity and can document their capacity to perform successfully.

## **II Design a Legal and Regulatory Program which Authorizes Public Private Participation Consistent with both Government and Business Practices**

PURSE has completed a preliminary baseline review of public-private partnerships (PPP) and private sector participation (PSP) related laws and regulations. The legal review has identified two primary areas that need be considered for legal and regulatory development in the coming year:

1. A preliminary study of the present legal and regulatory structure has identified the need for researching and analyzing existing PPP/PSP laws/decrees and regulations and developing preliminary drafts of proposals for new or amended decrees and regulations for PPP/PSP. The study should focus on enabling legislation as well as process legislation. The PURSE legal advisor will recommend changes to existing regulations that will permit local government officials to initiate and administer the implementation of public private partnership projects as well as private sector participation projects.

Chemonics believes that the baseline review and legal analysis will provide the GOI with a clear understanding of the existing legal and regulatory environment as well as guidance (from legislative and regulatory drafts) that will enable the GOI to begin serious discussions on the implementation of new or revised decrees and regulations that more fully support environmental infrastructure development through public private partnerships. Chemonics also recommends that any proposed legislation utilize information and knowledge gained from developing actual PURSE demonstration projects.

- 2 The legal review has demonstrated that there is a need for regulations which require developers of major new residential towns and/or large commercial and industrial facilities (enclave development) to install infrastructure for water and waste water systems during the initial construction phase

PURSE also believes that the GOI should *seriously* consider regulations this year which require all developers of new towns and major new or expanded commercial and industrial development projects to build the environmental infrastructure needed to service their developments. All enclave infrastructure should be designed so that it can be easily connected into large area networks that transport and process clean water and waste water, should major municipal infrastructure networks be constructed in adjacent developed areas at a later date.

It is far less costly *to government and to users* if infrastructure is built by private developers during the initial project development phase. (This is a routine requirement in the United States.) Developers of new towns and commercial and/or industrial enclave projects should be required to operate within a regulatory framework which — puts forth a legal mandate to build infrastructure during project development. In addition, all new projects should be required to meet minimum government approved design, construction and operating guidelines as well as environmental quality standards for water, waste water and solid waste facilities.

PURSE believes that this *regulation will significantly reduce the cost of new infrastructure* development to the GOI and will insure that most of the new development that occurs in Indonesian urban centers will have satisfactory environmental infrastructure. PURSE is concerned that the future cost of urban infrastructure development is so great, that a failure to implement this cost saving requirement will result in an inability to fund, through any means, the moneys that are necessary to build the infrastructure that Indonesia desperately needs now and in the future.

### **III Develop Standards for Design, Construction and Operations for Sanitary Landfills, Solid Waste Transfer Facilities and Waste Water Treatment and Distribution Systems**

Discussions between the PURSE and GOI staff have confirmed the need for a more comprehensive regulatory environment that provides guidance and minimum standards

for the design, construction and operation of waste water treatment/distribution systems and solid waste facilities including sanitary landfills and waste transfer stations. Regulations and guidelines for the development of waste water and solid waste facilities do not exist in Indonesia at the present time. Standards are needed to insure the completed facilities will have a beneficial impact on the environment and that government officials will have uniform criteria which they can apply to waste water and solid waste project development and implementation.

Comprehensive regulations (and subsequent enforcement mechanisms) are needed as a baseline guide for both governmental and private sector groups that are developing, financing, and operating public private partnership projects. The guidelines and regulations are necessary in order to give guidance to private sector officials who design, build and operate solid waste and waste water facilities and to provide a uniform reference for project scopes of work, legal documentation and memorandums of understanding that will be developed between governmental agencies and private sector consortiums.

#### **IV Develop a Project Risk Management System using Financial and Performance Guarantees for PPP Projects**

Chemonics is finalizing a report that will provide GOI officials with a comprehensive understanding of project financing structures and the project performance and financial risks that are an integral part of all business transactions including PPP projects. Project risks can be defined as potential events that expose government agencies and private sector development partners to unexpected problems that will have an adverse impact on project performance and/or result in additional financial costs. These risks include market risk, construction risk, completion risk, interest rate and exchange rate risk, and project performance and operating risk.

The study on financial risks has focused on two major areas. One is project performance risk, and the other is project financial risk. We have identified a number of specific projects whereby the incomplete use of performance guarantee mechanisms has resulted in major financial losses to the Government of Indonesia. We have also uncovered problem projects in other countries where government and/or the private sector has been unfairly burdened by failures of one party to perform in accord with the development agreement.

Our report (and subsequent guidelines) will define and highlight financial and performance risk issues and will give GOI officials an understanding of the importance and value of risk guarantee mechanisms as well as the knowledge needed to apply risk management procedures to public private partnership projects. We believe that the application of risk mitigating measures (i.e. Risk Diversification) will result in more effective projects for the GOI and will help to reduce the substantial financial losses that were incurred from previous PPP projects that were carelessly implemented. We believe that the long term results of this effort will provide enormous benefits to the GOI.

### **Risk Diversification**

Chemonics will recommend that the GOI consider adopting a project risk diversification strategy where project financial and performance risks are shared between project principals. The objective of risk diversification is to balance project risks so that all parties to a transaction have a vested financial interest in the successful development and operation of PPP projects. Risk diversification should not be interpreted as an attempt to avoid or eliminate all risk.

Project principals have a powerful incentive to perform in accord with the partnership agreement if they have accepted a major financial liability for performance failures. The higher the potential cost of failure, the more incentive that each party will have to work toward the development of financially and operationally viable projects. In addition, the perceived cost of failure will focus intense scrutiny on project feasibility and bring added discipline to the entire development process, as many proposed projects that appear to have defective designs and faulty market assumptions will be redesigned or screened out of the development process prior to implementation. (This process is known as 'market discipline' )

### **V Design a Capital Market Financial Instrument (i.e. Revenue Bond) for PPP Projects**

PURSE will also propose that the creation of a *capital market tax exempt financing instrument* (i.e. a Revenue Bond) for water and waste water projects be considered by the Ministry of Finance with the support of the Ministry of Public Works, the Ministry of Home Affairs and BAPPENAS. We strongly recommend that the GOI look toward

the creation of policies and policy tools (Infrastructure Revenue Bonds) that encourage the financing of water and waste water infrastructure costs with local currency instead of foreign currency. We believe that it is imprudent to finance urban infrastructure with substantial amounts of foreign currency, especially when foreign component costs usually do not exceed 20-30% of project costs.

Chemonics has reviewed private sector projects proposed for Indonesian cities where the private project consortium planned to finance all of the project costs with foreign currency (in that case with US dollars/US dollar interest rates are at historic lows at this time and are subject to upward or downward revision by the US Federal Reserve Bank at any time) using adjustable interest rates (*Adjustable interest rates* means that interest rates on project loans can readily be raised or lowered with changing market conditions). There is an incentive to finance in dollars now because dollar denominated interest rates (the cost of debt) are lower. Lower interest rates reduce debt repayment costs and enhance project profitability.

It is apparent that this financing mechanism was proposed because the nominal and real interest rates for Indonesian debt were much higher than the interest rates for dollar loans, even when factoring in expected devaluation formulas. We believe this factor could be mitigated by the introduction of a tax exempt financial instrument (Water and Waste Water Revenue Bond) which would carry a lower interest rate and be competitive with foreign currency financing. Chemonics feels that this type of financial instrument is viable for Indonesia and would not adversely impact on future tax receipts, since the bulk of the users would be residential customers that pay user fees (i.e. user tax).

The proposed PPP projects that we reviewed did not provide a thorough analysis of the potential financial risks that could occur if foreign interest rates were raised quickly or if there were a major devaluation of the Indonesian Rupiah against the US Dollar. In fact, the potential liability to Indonesia would have been in the tens of millions of dollars and would have almost certainly required a central government bailout if serious problems would have occurred due to increases in US interest rates.

Financing local currency expenditures with foreign currency debt subjects the GOI to significant foreign currency risk and negatively impacts GOI/Ministry of Finance current account and monetary policy objectives. In addition, foreign currency financing

could adversely impact the future availability of foreign currency debt needed for export oriented economic investment, thus retarding future economic growth and job creation. Chemonics would like to continue its focus on this issue and provide the GOI with information and recommendations on local financing mechanisms that would encourage the mobilization of Indonesian capital market funds to finance urban infrastructure.

## V Develop Financial Models for BOO/BOT Projects

PURSE has spent a great deal of time studying existing Asian infrastructure financial models. One major model has evolved from our review which appears to be workable for Indonesia as well as other advanced developing countries. In essence, this model would require a financing structure composed of 75% debt financing and 25% equity financing (with at least 20% of equity in cash and up to 5% as an in-kind contribution such as land).

The development structure would consist of a private sector consortium and a GOI counterpart agency. The project would be owned by a corporation (the ownership entity) established for the project and managed by the private sector group, but government agencies would be allowed (and if fact encouraged) to hold an ownership interest. The consortium would own the project/corporation for a predetermined period of time (the concession period), and would agree to transfer ownership to a designated government agency after the concession period.

The financing of the project would be secured by a take or pay contract(s) and by revenue payments received from government agencies and private commercial/industrial users. ('Take or pay' contracts require that the party receiving the product (in this case, water) agree to *take* a minimum amount of the product every day and *pay* a pre-determined price. The receiving party is required to *pay* the daily price even if they are unable to *take* or use all of the product.) The take or pay contract(s) would require that a minimum amount of water be purchased every day resulting in a fixed payment that would assure revenues to the project were adequate to meet operating expenses as well as 125% of debt servicing (debt repayment) costs. Any additional usage of water above the minimum daily amount would increase project revenues and enhance profitability.

Project developers would need to demonstrate previous experience with the development and operation of large water systems (an important requirement of lending

institutions such as banks) and would be required to provide a guarantee of completion of construction. In addition, the private sector ownership consortium would have to provide substantial credit worthy financial guarantees that the project would consistently operate and perform in conformance with pre-agreed operating standards for both output and quality. Failure to meet performance tests would involve the payment of monetary penalties (or partial project reconstruction) in accord with a schedule of liquidated damage payments.

Upon completion of construction, the project would be operated by the private consortium until the end of the concessionary period. During the period of the concession, project revenues would be used to pay for ongoing operating and maintenance expenses, retire the outstanding corporate debt, and repay project equity to the private equity investors. Additional revenues would be allocated as profits to the private consortium. In most projects, we would expect that the local government and the private consortium would engage in some form of profit sharing after the private sector exceeds a pre-defined return on invested equity.

### **Other potential financial models**

Developing models for BOT/BOO projects is very important, and PURSE believes that we should continue designing other financial models that would be appropriate for Indonesia. We will study other models including a 90%/10% debt/equity structure where local government agencies would be full partners and have more opportunity to share in cash flows. We will also study turnkey models, where the ownership of the project is turned over to the public sector after completion of construction and upon the acceptance of sustained project operating performance in accord with pre-agreed criteria for output and quality. (Other financing models are also being developed.)

### **Additional Project Risk Issues**

There are four remaining (These are by no means inclusive) issues which impact on the development of project models. The first issue involves legal risk, and the second and third issues are currency risk (also profit repatriation risk) and market risk. The fourth issue is the structure of tariff policies and rate setting mechanisms.

### **Legal Risk**

Legal risk is a problem because Indonesia does not yet have a viable commercial legal system where disputes can be adjudicated through a proven and unbiased institutionalized legal system. An undeveloped commercial legal system leaves lenders and project developers exposed to unilateral actions by government which may adversely impact on project feasibility and economic viability and threaten project loan repayment. This occurred recently in Thailand when the Thai Government lowered highway tolls after a toll road project was completed.

In order to obtain foreign and (possibly) local currency loans for PPP Projects, it might be necessary to mitigate legal risk through the development of a partial sovereign guarantee mechanism where the Ministry of Finance would guarantee an 80-90% loan repayment should a local government agency default on its financial obligation. The development of the guarantee mechanism would be complicated, and the guarantee mechanism would need to be balanced so that GOI/Ministry of Finance debt policies and debt risk management programs would not be adversely impacted. A guarantee mechanism would need to be designed so that project developers and lenders would not be looking solely to the Ministry of Finance to underwrite (evaluate) their projects at the expense of project feasibility underwriting.

Sovereign guarantee authority is an 'insurance policy' and would have to be purchased from the MOF. Annual guarantee authority would be regulated by the MOF, and project applicants and local government agencies would need to apply to the Ministry for authority to use guarantees. In the event of default, both the private sector and the local government agencies would incur monetary penalties. The potential for loss by both local government and the private sector would provide an incentive to resolve disputes without defaulting on project obligations. In addition, the use of international dispute arbitration systems should also be explored as a means to adjudicate serious problems between project developers and local governmental entities (The Ministry of Finance and the Ministry of Home Affairs would guarantee performance of arbitration rulings).

### **Foreign Currency Risk**

Developers of infrastructure projects may need to borrow a portion of the project debt in foreign currency in order to pay for foreign purchases. Unlike commercial projects, where some product is usually exported and foreign currency revenues are earned —

through foreign sales of product goods or services, infrastructure projects revenues are usually earned only in local currency

This creates a risk of default of foreign currency payments should convertibility of local currency to foreign exchange be restricted or made difficult due to unexpected changes in economic conditions. It is important that measures be undertaken which alleviate or reduce this risk through the purchase of guaranteed exchange rate convertibility insurance through MIGA or OPIC or the purchase of Rupiah/Dollar currency swaps through one of the local commercial banks that are making a market in financial derivatives. The private sector should also request assurances from the Ministry of Finance that currency conversion will not be restricted.

### **Market Risk**

BOT water supply projects will be developed in order to provide water to users and consumers (i.e. the market). Large BOT projects must be designed to address future water needs that can only be estimated using existing data on water usage and future usage projections. Future demand projections are impacted by population increases, economic growth and other factors which effect water usage and can only be estimated. In planning PPP/BOT projects, local government agencies must be careful not to overestimate future demands based on highly optimistic market assumptions.

Local government officials need to be cognizant of the future financial liability that will be incurred as a result of PPP/BOT development. If local governments commit to major financial obligations for BOT projects based on faulty assumptions concerning future usage projections, the commitments could lead to serious financial difficulties in the future. Project planning needs to be sensible, and it should take into account realistic assumptions about future demand through a system of phased planning where necessary. Phased planning will permit new capacity to be added as needed without creating undue financial burdens from projects which have too much productive capacity.

### **Tariff Policies**

PURSE believes that the structure of tariff mechanisms for PPP projects will be of particular importance to the private sector. During our meetings with private sector

officials (including representatives of Bechtel, Flour Daniel and Parsons and leading Asian legal, banking and investment banking officials), we were given the clear impression that tariff issues including rate (tariff) setting, the development of formulas for rate adjustment mechanisms and local government controls/policies for rate adjustments are a key issue for private sector developers and financial institutions PURSE recommends that the tariff issue be given a great deal of attention and that consideration be given studying alternative models and policies for tariff setting

### **Conclusion**

We at PURSE are deeply appreciative for the opportunity to address this roundtable discussion We trust that the discussion here today will result in a more focused understanding of the major issues and problems that confront this new initiative and will lead to clear directions for this important project Solving Indonesia's environmental problems is a big task for all of you, but we believe that your demonstrated commitment to go forward will achieve positive results We look forward to continuing to work with all of you in the spirit of cooperation and friendship Thank you

# PAPER III

# **Private Participation in Urban Services**

## **PURSE ROUND TABLE SEMINAR**

### **Issues Impacting Upon The Policy Framework For Participation Of The Private Sector In The Provision Of Urban Services**

Prepared by

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The PURSE Project is sponsored by

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## 1 General Policy Environment

### **Basic PPP Policy Assumptions**

Macro/global policies expressing the GOI's commitment (i.e., political will) to pursuing the PPP (Public Private Partnerships) or PSP (Private Sector Participation) option for provision of infrastructure are already embodied in the current legislation, as well as numerous public statements by both the President and his ministers. What is now required is a second tier of more detailed policies backed up by updated legal statutes, technical standards, bidding and contractual procedures and promotional activities to support implementation.

The following newspaper article dated August 20, 1993 from the 'Jakarta Post' highlights the current legal problems and the government's sense of urgency:

**The government has set an ambitious target to replace all 400 laws, the legacy of Dutch colonial rule, still extant 48 years after independence. The National Law Development Board (BPHN) announced [19 August, 1993] that it hopes to phase out about 70 colonial laws each year during the next five years and replace them with legislation more in line with national aspirations.**

**BPHN Chairperson Sunaryati Hartono described the effort as a "crash program". But she told reporters that there are now only 50 people in Indonesia with true expertise on Dutch Laws, the Anglo-American legal system, the Dutch language and legal development in general. "All of them are aged over 60 years", she said.**

**Meanwhile BAPPENAS said that legal development will become a main issue during the Sixth Five-Year Plan (Repelita VI) which begins next April.**

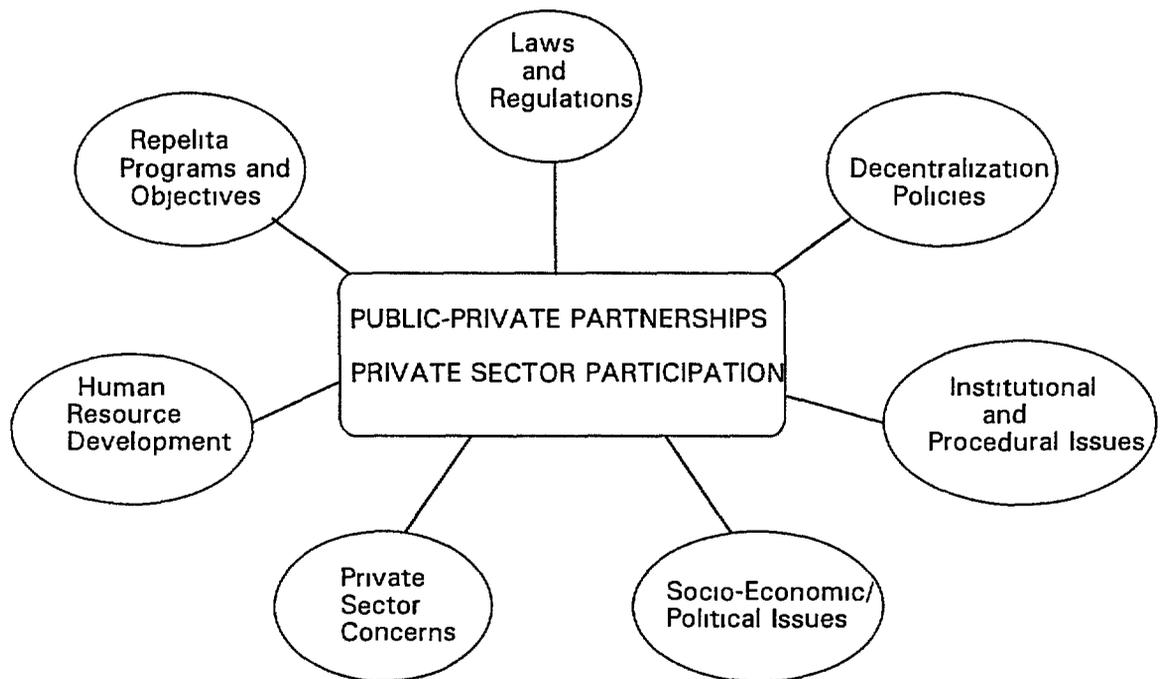
The private sector as well as local government is now looking to the Central Government for further guidance and leadership on procedural, financial, technical and legal issues.

Public Private Partnerships, like any development initiative, are heavily influenced by other tangential factors which must be assimilated if a workable, implementation-orientated policy framework is to be found

The Indonesian policy environment is perhaps more complex than most because of the many development priorities which are all competing for limited funds Added to this is the highly centralized bureaucracy to which local governments must ultimately answer

The basic approach and methodology for analysing the issues discussed in this paper are outlined in the diagram below

### PPP/PSP POLICY FRAMEWORK



Because of the strong role of the Central Government Indonesian policy makers are forced to view all development initiatives from an interdepartmental as well as

intersectoral perspective. This fact means that the policy framework in the diagram actually exists on two planes: 1) the Daerah or Pemda policy environment, and 2) the Pusat policy environment. Private sector investors are well aware that for Daerah based projects they must deal with both levels of government. Despite the admirable progress in regional autonomy and decentralization, the daily reality is that all roads still lead to Jakarta.

The main problem which now restricts more private sector involvement in PPP and PSP, is that both Local and Central Government are still unsure as to how they should deal with the private sector on certain legal, procedural and technical issues. The Policy Framework diagram is an attempt to define, and address these issues.

## **2 Laws and Regulations**

The laws which are currently used as the basis for PPP/PSP projects are Kepmendagri 3/1986 and Kepmendagri 4/1990. The first (3/1986) covers the participation of local government capital in private profit-making commercial ventures with third parties. The second (4/1990) covers the procedures required for local government enterprises, or Badan Usaha Milik Daerah (BUMD), to work with third parties.

Each of these ministerial decrees, and the issues arising from them, is administered by a Sub Directorate in the Ministry of Home Affairs. In the case of 3/1986 the administering agency is SubDit Penyertaan Modal Daerah (Participation of Local Government Capital), which is under Directorate Keuangan Daerah (Regional Finance), Directorate General PUOD. For 4/1990 the agency concerned is SubDit Bina Perusahaan Daerah (Support of Local Government Enterprises), which is under Directorate Bina Pendapatan Daerah, Directorate General PUOD.

The authority and involvement of each SubDit is determined by the way in which local government or Local Government Enterprises (BUMD's) choose to work — with the private sector (third parties)

The SubDit Penyertaan Modal Daerah must be consulted if local government assets such as land, buildings or capital are to be used as equity in private sector projects. If a third party wants to work with a local government enterprise, such as a PDAM or PDK, then they must work through SubDit Bina Perusahaan Daerah

The two laws mentioned above appear to have a degree of overlap. For instance, in both Kepmendagri 3/1986 and 4/1990 the reporting and approval requirements to the Kepala Daerah and Minister of Home Affairs are very similar. Both laws also allow the same types of business formats for working with third parties. It is also expected that after the joint enterprise reaches the profit making stage a percentage of the profits, in accordance with the agreement will go into local government revenue (Kas Daerah)

It appears that the P T company established under both Kepmen 3/1986 and 4/1990 are very similar in form to a BUMD and will have to operate under very similar conditions given the extensive role of the Kepala Daerah

This in itself neither good nor bad as long as professional profit-oriented management is used. However, given the pivotal role of the Kepala Daerah there is also considerable scope for political interference in the operational management of the joint enterprise. This could be viewed as a disincentive by the private sector

The GOI's objectives for urban infrastructure development are generally supported by central government actions. However, key issues which impact on the willingness of local governments to enter into PPP/PSP projects are not being dealt with at Tk II level

The current legislation is focused on defining and monitoring the use of Pemda assets and/or the involvement of BUMDs who wish to enter into joint ventures with the private sector. However, this legislation does not encourage Pemda or BUMDs to actively seek such joint ventures. On the contrary, regulations 3/1986 and 4/1990 in their current form could be seen by local government officials as a disincentive to private partnerships.

Historically local government officials have preferred the less complicated approach of simply selling, swapping or leasing Pemda assets.

The argument that the PPP or PSP approach will increase PAD (Pendapatan Asli Daerah - Local Government Revenues) and reduce the burden for regional development on the Central Government may be justification enough for central government agencies, but a more convincing argument needs to be found to entice Pemda Tk II into real PPP or PSP projects.

Failing this, new legislation could be introduced to discourage the sale of Pemda assets. Instead, some appropriate form of PPP arrangement, with medium to long-term income prospects, could be made mandatory if Pemda assets were to be used for economic/commercial purposes.

#### **Laws and regulations pertaining to the management and provision of water supply, waste water and solid waste services**

The GOI's laws and regulations, although somewhat ambiguous about the management of water resources by non-government entities, have not prevented private sector firms from engaging in water and solid waste joint ventures or service contracts. If these ventures have had problems it is usually because of the poor understanding that Pemda officials have had about commercial realities. In some cases private sector firms have also tried to take advantage of this situation.

A good example of this can be found in Surabaya where contractors are only given 3 month contracts to collect garbage and sweep the main roads. After each 3 month period the individual contractors are then moved to a new location where they have to recruit a new work force. This type of system exploits small local contractors who are obviously prepared to work under difficult conditions.

Although cheap, this type of arrangement will not provide an efficient or comprehensive municipal waste management system because contractors have no medium term financial security and are therefore unable to secure loans for investment in new equipment. Government must be aware of the financing issues which are faced by private investors and structure contracts accordingly. Guidelines on how to draw up service contracts and management contracts would definitely help.

### **Water Supply - Public Versus Private**

Of the three sectors mentioned above water supply presents the greatest challenge from a legal and policy perspective. Water has both the characteristics of a private good - for sale, and a public good - which needs regulation in the interests of the common good.

A piped water supply has the characteristics of a natural monopoly. The investment cost is high and the system requires large economies of scale to be commercially viable. Also the likelihood of competing water systems is highly unlikely in any given service area. (Although, in Indonesia most PDAM systems do have to compete to some extent with private wells). These monopoly characteristics make large water supply systems very attractive to the private sector.

Obviously the social and wider economic significance of water requires government involvement to allocate monopoly rights, regulate prices, monitor performance, and often to provide the most expensive up-front infrastructure.

investments such as dams, head works and large pipe mains. However, this does not mean that public operation is essential, or the best option available.

Although day to day competition in the market place is not practical, it is possible to introduce incentives for efficiency through competitive bidding for contracts to operate services. In theory, as long as competition is fair, it should not matter whether the competing firms are publicly or privately owned.

Regulating and monitoring the private provision of public services is a complex and difficult responsibility. The regulating agency, or agencies must establish financial and technical standards, design transparent procedures to select operators, monitor and evaluate operators' performances, periodically renegotiate contracts and revise standards.

The more the private sector is involved in the provision of a public service, the more regulations have to be defined and enforced. For instance, the regulatory framework for concession contracts such as "Build Operate and Transfer - BOT" must be more comprehensive than for simple service contracts. Standard contracts and transparent award procedures are important components of an effective regulatory framework.

Under the BOT option (sometimes called a public works concession) the private sector is asked to finance new facilities, to operate them and to turn them over to public ownership at the end of the concession period. The USAID WASH study stated that the difficulties the Government has experienced in concluding negotiations of the few BOT schemes which have been considered so far can be attributed to

- 1 the absence of a clear regulatory framework to guide the awarding of a public service to a private entity,

- 2 the limited experience of the Public Authority in negotiating such schemes which often are supply driven, i.e. initiated by private investors rather than by the Public Authority,
- 3 differences of view between the Central Government agency and the local water enterprises on the desirability of the proposed schemes,
- 4 an overly restricted competition, and
- 5 the political consequences resulting from the high cost of water to end users caused by the high cost of commercial borrowing

### **Solid Waste Management**

The efficient management of solid waste in Indonesia will have to be done with a combination of technology-intensive and labour-intensive methods. Examples of both can already be seen in the track record of private sector involvement in this sector.

The WASH team reported a number of obstacles to private sector involvement in the more technology-intensive aspects of solid waste management. These can be summarized as follows:

- 1 Most local governments are generally reluctant to engage contractors for waste collection if they don't already own trucks.
- 2 The competition from multilateral funds for waste collection vehicles via IBRD or ADB projects such as IUIDP's Urban Development Projects (UDP) make it difficult for private sector contractors to compete. Local governments like to get the heavy equipment but often have major problems getting funds for O&M after the initial disbursement of the UDP project.

funds This usually happens because no matching provision for O&M is made in the routine government budgets

- 3 Private ownership and operation of collection systems and sanitary landfill sites is generally supported by most local governments and Dinas Kebersihan officials but the high cost of equipment and land has been a persistent obstacle for private sector investors The special permissions required for digging large holes and safeguarding ground water resources from potential leachate contamination are also difficult to acquire in the absence of nationally accepted design and operating standards

Current experience clearly proves that there is still a large role for labour-intensive methods in Indonesia within an integrated solid waste management system

### **3 Institutional and Procedural Issues**

Progress in promoting genuine PPP and PSP projects as opposed to selling off or leasing government land, has been quite limited Officials in SubDit Penyertaan Modal Daerah attribute the lack of progress, in part, to the following factors

- 1 In general, local and regional government, as well as the private sector, are unaware of the opportunities inherent in Kepmendagri 3/1986
- 2 Most local and regional officials do not fully understand how to form partnerships and therefore prefer the easier option of selling LG assets
- 3 As a consequence of points 1 and 2 there has been very little effort invested in promoting these types of projects

- 4 In most cases LG brings less equity and investment to projects than is needed to motivate the private sector. The undervaluing of LG assets contributes to this problem.
- 5 LG officials often need assistance with evaluating feasibility studies, sophisticated equipment and construction techniques.
- 6 Likewise legal and procedural guidance is needed to determine investment amounts, most appropriate type of contract, duration of partnership and profit sharing.
- 7 There is no comprehensive inventory of LG assets at either Central or local government level from which the private sector can "shop" for potential projects.
- 8 The provision of the guidelines, manuals and assistance outlined in points 5, 6 and 7 have not been forthcoming due to funding constraints within PUOD.

It is apparent that there is significant scope for PURSE to assist in the efforts of SubDit Penyertaan Modal Daerah to promote, facilitate and monitor PPP/PSP projects. Whether or not they will have the resources to begin their ambitious program will depend on the outcome of their 1994/95 DIP.

#### **4 Decentralization Issues**

Many of the difficulties encountered in promoting PPP and PSP projects at the local level are closely linked to the practical and policy issues which are also impeding decentralization efforts. The debate on decentralization is highly politicized and involves, among others, the following issues

- What really constitutes decentralization?

- Should decentralization be promoted by increased financial autonomy through larger untied block grants (Inpres Dati I and Dati II)?
- Do all local and provincial governments (LG) have personnel who are capable of handling significantly increased technical and financial responsibilities? If not should the level of decentralization be commensurate with LG capability? If so how should this capability be assessed?

Perhaps the most problematic of these are the extensive reporting and approval procedures that local governments must undertake to seek approval for even minor matters. For instance, almost every stage of the procedures outlined Kepmendagri 3/1986 and 4/1990 require final approval by the Minister of Home Affairs.

What this means in reality is that local government officials and their private sector partners for any PPP/PSP venture have to frequently travel to Jakarta to lobby for their projects and push their documents through the central bureaucracy. Local government officials also expect that these costs will be borne by the private sector partner. This adds significant costs to project preparation and acts as an effective deterrent to the private sector unless the project is large enough to justify such costs.

These administration and lobbying costs mean that private sector investors will be forced to consider only those projects which have high internal rates of return and a scale of operations large enough to absorb these start-up costs. The result will be that many smaller, but worthwhile projects, will not be considered by locally based private sector investors, and that only the richest of local businessmen will be able to consider such projects.

## 5 Selecting Appropriate Contracting Options

One of the first questions government officials often face in planning for private sector participation in municipal infrastructure services is to define what form of private sector participation is most appropriate. Should it be a short term service contract, or a longer term operating contract for a major capital facility? Should it be a substantial private capital investment to develop new technology or new facilities?

Generally speaking contract options with private sector firms fall under two main categories

- (1) *private sector participation (PSP)*, where the private sector sells services (such as meter reading, street cleaning, vehicle repair) to the government under close government supervision, and
- (2) *public private partnerships (PPP)* where the private sector provides significant capital investment and often has a say in the management of large infrastructure facilities

*Private sector participation (PSP)* is the most basic and direct way to structure private involvement in infrastructure services. It can be structured in two ways

- (1) A Service Contract, where a private entity provides a routine service such as repairs to pipes, scheduled maintenance of vehicles, collection of solid waste, or meter reading. Typically, a service contract is short term, involves no significant private investment, is focused on a well-defined task, and is closely supervised and controlled by a government agency

Service contracts are often used to procure routine services at lower cost, or with more flexibility, or for a shorter term, than is possible through a government agency

This type of contract is now common in Indonesia. Many water authorities and solid waste management agencies contract for basic services

- (2) An Operating Contract, where a private entity assumes overall responsibility for operation of a system such as a water supply system, with the ability to make daily management decisions

An operating contract is typically medium term (say three to five years), involves a significant private capital investment, addresses a wide functional agenda, transfers significant responsibility to the private entity, and is controlled by general oversight based on management standards

Government agencies enter into operating contracts to acquire technical skills, management expertise, higher quality service, and staff training

This type of contract is not yet common in Indonesia, but some of our local water authorities and solid waste management agencies have contracted for management of solid waste transfer stations, centralized billing and collection systems, and similar activities. I expect that this type of contract will gradually be used more widely in Indonesia

*Public private partnerships (PPP)* are a more complex form of private involvement, because they generally include the investment of significant private capital. As a result, the government and private business firms must truly become partners. There are three basic forms of private sector participation (PSP)

- (1) A Turnkey, where a private entity constructs an infrastructure facility and turns over the ownership of the facility to the governmental agency upon its

acceptance after completion of construction. In most instances the private entity finances the facility during construction.

The turnkey approach is used to obtain low development cost, high quality construction, adherence to schedule, construction period financing, assurance of certification for initial operation, or specific development management skills, often for facilities with demanding technical standards.

This approach has not yet been used in Indonesia for municipal infrastructure.

- (2) A Build/Operate/Leasehold Transfer (BOT), where a private entity is responsible for the financing, construction and operation of a facility during a long leasehold period of perhaps 15 to 20 years. During the leasehold period, the private entity owns the facility. At the end of the lease period, ownership of the facility is transferred to the government agency.

The BOT approach is used to substitute private investment capital for public funds in the financing of infrastructure. The provision for the transfer of the facility to public ownership at the end of the leasehold period permits the government to control the operation of the facility, and to eventually add the project to its asset base.

The BOT approach has been widely used in Indonesia for power, telecommunications, and toll roads. The experience in these sectors has provided models for our more recent initiatives in municipal infrastructure.

There is one large BOT project completed and operational in Indonesia in water supply; this is in Denpasar. Several other water supply projects are being planned, some of these are now actively under negotiation.

The first large BOT in solid waste, a hazardous landfill and treatment facility, has just become operational near Jakarta. There are several active proposals in negotiation for transfer stations and landfills through BOTs.

- (3) A Build/Own/Operate (BOO), where a private entity is responsible for the financing, construction and operation of an infrastructure facility. In addition, the private entity retains ownership of the facility.

The BOO approach is used to permit complete privatization of selected infrastructure facilities in exchange for private acceptance of a wide range of risk, based on public policy considerations.

This approach has not yet been used in Indonesia for municipal infrastructure.

## **6 Private Sector Concerns**

Globally speaking private sector firms, especially the more wary foreign investor, have similar basic concerns about what can generically be described as doing business on a "level playing field". The GOI needs to take serious steps towards addressing private sector concerns regarding

- ambiguous and unclear regulations,
- enforceability of contracts,
- use of appropriate technology,
- government guarantees for payment (in the case of "take or pay" contracts),
- high overhead and establishment costs caused by unofficial levies,
- impartial arbitration of disputes,
- cost effective management in the running of PPP enterprises,
- difficulties in obtaining reliable data about Pemda assets,
- fair, open and transparent tendering

## 7 Specific Conclusions

Most new development initiatives in Indonesia appear to go through a number of recognizable stages. To a significant degree the development of public private partnerships in the provision and management of urban environmental services also seems to have followed these stages.

**The first stage** is usually the "Political" stage. This begins with a statement of political will which usually expresses the government's commitment to deal seriously with a particular obstacle to development. In this case the enormous investment needed in urban infrastructure to maintain planned, and projected rates of economic growth for the Indonesian economy. Usually this commitment is also backed up by some hastily prepared regulatory gesture such as a Presidential decree, Ministerial decree or deregulation decree which can be issued and gazetted far quicker than a full Undang-Undang.

**The second stage** is characterized by a short-term speculative rush of private sector entrepreneurs and entrepreneurial government officials trying to take advantage of any opportunities that may immediately be apparent under the new legislation. Most of these early attempts are usually unsuccessful.

**The third stage** is the amelioration stage where concerned government departments try to assess the damage that has been done, patch up problematic projects, derive lessons from recent experiences, identify holes in the current legislation, and formulate new policies, laws and guidelines to provide the regulatory framework that should have been prepared in the first place.

It appears that the public private partnership initiative is now in the third stage. Logically the first stage of amelioration should be a prioritization of issues by urgency, or in other words, those problems which are preventing further progress should be dealt with first. Findings to date suggest that the most urgent problems

are the legal and institutional issues covered in sections 1 and 2. If these issues are not addressed then the project-by project-muddle-through-approach will continue to be used.

As past experience has shown a lack of legal and procedural certainty allows officials to make policy as they go. This situation substantially increases the cost of projects and results in long delays as officials try to secure Surat Keputusan (Decrees from the Kepala Daerah and/or Ministers) to approve key aspects of each project and cover themselves legally.

Interest from the private sector in PPP or PSP projects will increase as the regulatory framework becomes more predictable. The legal and procedural issues in section 2 need to be addressed to provide the level playing field needed to attract more genuine private investors, especially the more cautious foreign investor. If the GOI wants to see more firms bidding for projects in competition with each other then the tendering process has to be seen by the private sector as open, free and transparent.

Of the issues discussed above, the most urgent priority should be given to the institutional issues discussed in section 3. As described by the Sub Directorate for Participation of Local Government Capital, PUOD, there is an urgent need for an information campaign to inform and educate central and local government officials about the true scope of the PPP and PSP option. Government officials also need to be aware of what their role should be in such an arrangement, and what benefits can be derived. Since public private partnerships cannot exist without a private partner it is appropriate that the private sector also be included in any information or education campaign.

Finally, it should be remembered that the private sector needs to take an active role in preparing the institutional, technical and legal framework required to promote and facilitate public private partnerships. Government agencies in Indonesia must be aware that the private sector will not respond to a government initiative just

because it happens to be in the Repelita. Since private sector firms are expected to play an important role in the implementation of projects, they should also be consulted during the formulation of operational policies for project implementation and management.

# PAPER IV

# **Private Participation in Urban Services**

## **PURSE ROUND TABLE SEMINAR**

### **A Discussion of Key Issues for Financing Infrastructure in Indonesia**

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**The PURSE Project is sponsored by:**

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I want to spend a few minutes and talk briefly about some of our experiences on how to finance the huge infrastructure needs in Asia as well as other parts of the world. In a fashion new to most of us, this will take us from public financing and from institutional sector financing (ie from the World Bank and ADB) to really private sector financing

I can assure you from my own experiences in the US through working with the State of Mississippi that it is no easier in some respects to finance infrastructure there than it is here. That's not very helpful but it is nice to know that everybody is struggling with the same issues all over the world. Let me just touch briefly on some of the things that I think are important when you start looking at financing one of these projects

I think that is important to try to understand what are the benefits of going to private project financing of infrastructure, because there seem to be a number of misunderstandings on both side in the aisle of what the benefits really are, what you get out of it, and what you don't get out of it

- 1 One benefit of trying to finance an infrastructure project in the private sector is that it allows you to utilize free market competition to achieve the least cost system. Whether it is a power plant or environmental facility does not matter so much as long as you have some degree of free market competition and people bidding in order to provide a service for that facility and for you. You are going to have a method of regulating the cost of that system that comes from competition, not from trying to figure out how to be smart enough to select which one is the best system for the lowest cost

In my opinion, that is one of the reasons that private power in the US has survived for more than a decade now. If it were not working and providing low cost solutions in the US, it would not still exist. But it does still exist, and I think this is one of the major reasons why it still exists and will continue to do so

Competition helps to achieve improvements in efficiency across the entire sector, whether it is power, environmental or another type of infrastructure. Because of competition, it helps to achieve self-regulation in that aspect of infrastructure, again power or environmental. And by doing that, it allows the redeployment of a lot of talent that otherwise might be trying to (inefficiently) regulate or oversee or even manage that particular aspect of the infrastructure

- 2 The second real benefit of going to private sector financing or project financing of infra structure projects is that it attempts to establish new sources of capital for these projects. What you are really doing is moving equity from multi-national corporations that want to invest in these projects, and you are moving debt financing from commercial banks and away from agencies like the World Bank. It very important to note in this regard, many of the misconceptions that are held on both sides of the aisle with respect of these types of projects are the same only that are held in major corporations when they start to try to complete a project financing on an off balance sheet basis.

In essence, because of the nature of these projects, they require a certain amount of recourse (financial obligation) to whomever is the sponsor (government) of the project. In many countries or political sub-divisions, for example the US State of Mississippi, agencies tend to control those functions in some cases, and they are the entities that are also either purchasing the service or overseeing the purchase of that service.

Many times there have to be some credit substances standing behind those purchases of the services. And the result of that is just like with the big company trying to finance a project off their balance sheet, it is very difficult to transfer the entire risk to somebody else. What big companies find is that, a lot of time they are not completely removing the project from their own balance sheet, but they are only half way removing it from their balance sheet. (Same with Government)

What we find in many instances with respect to these infrastructure projects is what is happening with countries as well. It is very difficult in the early stages for the entire risk burden of projects to be shifted completely away from the public sector. In many cases even when you go back to United States and you look into private power, it is true that there is tremendous government regulatory oversight of all private power financing. That is also true in the United Kingdom, which has also done a lot of private power financing.

To finish the point, it does establish new sources of capital. It is somewhat a misconception to call it completely private power where a lot of people ask if it is a private power, then what has the government got to do to help implement the project or stand behind or support the project. And the answer to that is, it is a little bit of both, it is not completely private and it is not a completely public. It does give you

access to new sources of capital but not a completely non-recourse basis Limited recourse - yes, but non-recourse -no So it does expand your available sources of capital but not on a completely autonomous (non-recourse) basis

- 3 Large scale technology transfer is one of other benefits of financing these projects or having private companies come into BOO/BOT facilities When you say technology transfer, we talk not only about the technical transfers but also financial and managerial knowledge and skills that get transferred in the process of financing these facilities

The benefits are somewhat broad reaching and it is important, I think, to understand what they are and not try to achieve The wrong objective may be to try to finance it completely off balance-sheet with no connection back to the government in many cases Because if that is the objective, in many instances, it will be very difficult if not impossible to achieve that, and people are bound to get frustrated trying to achieve an objective that is really not achievable under most circumstances

Of course, what allows you to put together these project financings is really a contractually supported arrangement, a series of contracts which tie together the various parties In the case of power project for example, you have got a utility that is going to be purchasing the power from the power (supplier) project There is going to be a power purchase agreement in the case of power plant, or in the case of other types of facilities there is going to be purchase of services or some type of products Those contracts will become extremely important in order to be able to carry out the project

The beauty of the project financing is that it allows the achievement of the objectives that I have just talked about and realizing the benefits that I have talked about It allows access to a variety of international capital markets It allows you to mobilize capital through a very efficient risk allocation process when you go through the contractual allocation of risk to the various participants in the project And again it comes back to not a non-recourse financing but limited recourse financing in which the risk are distributed by virtue of the contract and limited by virtue of the contract to various parties including the government in many instances

The credit (financing) from the standpoint of the capital markets is really based on risk analysis of the project itself which goes into full technical analysis of the project It goes into an analysis in the terms of various contracts that knit the different parties together, and

in addition to that, the third element is very important, it goes to not only the terms of the contract and the risks of the project - but also to the credit worthiness of the parties who are signing the contracts

It is very important that one of the key issues that comes up time and again in financing private power (which is government owned across this region and elsewhere in the world as well), is the utilities themselves do not have independent credit (rating) substance apart from their governments As a result of that, when private companies sign contracts with government owned utilities for example, we are going to be looking for some verification from the government that they are going to stand behind the credit substance of the utility company Because the utility company in those instances really exists on behalf of the government, the government decides whether the utility is going to survive or not

So for companies that are outside the country, when they come and sign a contract with the government owned utility, they are going to be looking for the government to confirm that they are going to keep the utility in place and that they will stand behind its credit substance, and allow it to charge whatever rate is necessary to be credit worthy, so that they can make the payments pursuant to the power purchase agreement or whatever other kinds of contracts that may have been signed

The most important thing to remember is that when you are doing project financing is that lenders to those project financings only have recourse to the contracts and to the physical assets of the projects So when lenders look into those contracts, they are very concerned about who is signing the contracts, whether or not in fact in the case of government owned utilities for example, the government has made some types of statements that they are going to stand behind that utility for the life of the transaction

The two critical aspects of security when you are looking at project financing or the physical assets themselves, in many instances, are not particularly of value to the lenders What is much more important are (1) the contracts themselves and (2) the credit substances (financial guarantees) that stand behind those contracts The physical assets may have some degree of value, but only if they produce a product and a revenue stream that produce sufficient cash flow to repay debt So again, it becomes extremely important to lenders when they are looking at these projects, to look at the purchaser (or whatever the product or service the project is producing) and to know that there is a credit worthiness (strong financial capability) that stands behind the project as long as it is produced by the project

One of the other characteristics that I think are important to touch upon with respect to international cross border project financing of environmental or power transactions or other kinds of infrastructures is that, in many instances, you are going to have local currency earnings but you are going to have foreign denominated capital (debt) because you have to buy foreign equipment or other type of equipment to finance the project. As a result of that, there is going to be some need to deal with foreign exchange risk in the project.

The second characteristic is that, just like other countries including the US and Europe, in spite of fact that you are going into sector private participation industries or sectors of the economy, that in almost all cases, it still requires some government oversight to ensure that public interest is served, whether in power sector or in environmental sector.

The third thing which is important to remember is that financing these project requires some sharing of responsibility with the government. One of the things required from the government is to help provide a proper foundation for the financing.

- 1 The first thing which is critical to providing a proper foundation is clear laws that regulate whatever the sector is (power or environmental sector, related to water or something else), clear laws regulating how that particular sector will work and what the rights and obligations of the various parties in that sector are. It becomes a really important part of being able to put together a contractually supported project financing.
- 2 The second thing that is very important with respect to these cross border project financings is some type of acceptable support for foreign exchange risks, when it is not possible to develop foreign exchange mitigation in the market through "hedging". The third is the acceptable support by government of the credit capacity of the off-takes (buyers) of the services or product.
- 3 The last thing is a sharing of the project risks in instances where the result is the least cost solution. With respect to this last point, one other thing that becomes very important when people look at project financing is that, it only raises only a certain amount of money. Once that money is gone, then, the project has a problem if the project (private consortium) has not completed the facility. So from a lenders stand point, it will look very carefully at how much money is already included in the basic financing package and whether or not that will be sufficient to complete the project.

# PAPER V

# **Private Participation in Urban Services**

## **PURSE ROUND TABLE SEMINAR**

### **Financing Models for Environmental Infrastructure**

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The PURSE Project is sponsored by

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First of all I would like to mention a few special considerations for financing of environmental projects

1 With infrastructure projects, we are looking at high capital cost/long term life assets, and, in order to obtain funds, you have to be able to match project capital needs with the term of loan availability from various lenders including the export credit agencies, development funding agencies (soft loans) and commercial bank debt

2 You will also face situations where the revenues often are going to be based on a user rate being paid by the ultimate users who are used to paying below market rates. In order to generate the revenues sufficient to pay back the loan in a reasonable time, you are going to end up having to live with market rate pricing

In addition, as PD Fyke said, it is going to be important to try to diversify the sources of funding so that you can obtain long term fund availability so you can reduce the negative impact of financing costs. The longer the availability (or term) of funds, the lower the user rate can be

3 There is also the point on the foreign currency debt and interest rate variation that PD touched on, so I am not going to go back on that one

4 There is also the fact that, very often in environmental projects, the entity which is responsible to by the project is going to be municipality. Indonesian state bank may know quite well what this or that municipality will represent. When it comes to dealing with the international banking community, however, you will find that banks offshore have, in general, very little understanding of how municipalities raise taxes, what other sources of revenue there are, what is their true credit worthiness really is. Therefore, banks are going to look at something much more than a straight forward and simple risk in order to get comfort that the entity (or municipality) assuming the payment obligations will be able to deliver on them

5 Then, of course a fact that was mentioned previously, there is an issue of competition between various potential investments for loan money from banks around the world. Even when it comes to political risk, which can be in fact be backed up by the GOI or other government guarantee in some cases, there may be a need for some additional factors where the banks are going to look at this transaction versus other

transactions where banks can invest, where other investments will also give them the level of adequate comfort they are seeking

- 6 Therefore, as was previously discussed, limited project finance guarantees insure that there is a way to open up additional sources of funds for financing infrastructure. It is a very useful approach because it gives a very strong basis for raising funding, but one unfortunately cannot view it as a shortcut or an easy solution. In fact, it requires tremendous other efforts by all parties, and as far as the authorities are concerned, the concept of limited recourse is the one to keep in mind rather than non-recourse, because the type of commitment and the extent of commitment one will need to give goes in certain cases really quite far in terms of providing that strong basis of support to the project lenders.

As the second part, I would like to mention to you an example of a transaction that we are currently working on in Turkey. Please forgive me for not giving out all the details because some of them are not finalized, but at least we can give the flavor of how a bank acting as financial advisor and who at the end of the day will also be in charge of raising the debts, goes about looking at the various risks that need to be properly mitigated. As I said I will cover this project rather rapidly, but that should at least will give you an idea how we are going about it. In this case, Thames Water and two Turkish companies obtained a BOT concession to implement the City of Ismed domestic and industrial water supply project. Taylor Woodrow is going to be the project manager for the construction and Thames Water will operate the project once it is completed,

The Government of Turkey, as you will see, provides a number of guarantees which are in fact very strong. One of them is to provide some additional funding in the cases of a shortfall (inadequate cash flow) of cash flow, but ultimately they also stand behind not only the municipal credit risk, but they can also be called to step in if the loan is not being paid back from the project revenues. The scope of work of the project itself includes the construction of dams and a large capacity water treatment facility, pumping stations and other associated items. It is quite a complicated project. There is a 15 year take or pay contract.

There is a special purpose company (a private consortium) which is being formed to raise the financing and to build and operate the project over the 15 year concession period. The shareholders are the three companies I mentioned, that is Thames Water and the two Turkish companies, plus the municipality which is also a small shareholder. The total cost is approximately US\$750 million.

When you look at the risk structuring for this project, you will see that project risk structuring is necessary for all the good reasons that PD Fyke mentioned. The bank (that in fact ultimately is the important decision) needs a very high level of protection against all project problems. There is really a question of trade offs to securing the longest maturity and getting a rating placed completely competitive with the market situation currently existing in order to be able to have access to the longest maturities available for Turkey, and that is the route that was chosen.

So we are looking at various risks that lenders are going to be concerned about

## **1 Construction Risk**

There is construction risk, and here without going into great depth, the local subsidiary of Thames Water and the two Turkish companies will have to provide a 'joint and several' commitment to complete the construction they are quoting on a fixed-price lump-sum turn-key contract basis, and the construction period is going to be over 36 months. They are, if you forgive the expression, on the hook for liquidated damages, and that is a sizeable amount of money that they have to put up if there are delays or problems with the performance of the plant.

In addition, they also have to make sure that the construction is going to take place, and that there are stand-by credits that are not expected to be used again which loans can be drawn if additional funding is necessary. This is really the way to address completion delay or abandonment cost.

## **2 Operating Credit-Risks**

Operating credit-risks of the lender (my apologies for talking about our side of it but it is important that when trying to raise money you will be able to see how the bank are going to look at it). As far as the operating risk is concerned, the bankers have strong security comfort with Thames Water as the operator, (because of their previous experience and demonstration of capability).

If certain (problem) events occur, the municipality has also agreed to make funds available on a subordinated basis for operations (an also on the construction side). So the municipality not only has an equity interest, but it is also ready to help make the deal happen, and ultimately, if the operating risks manifest itself to a degree which

prevents the repayment of the loan, the municipality will assume the debt. You have to keep in mind that the municipality should in principle never have to face that, but it is the second level of recourse that the lenders have (and that reduced lender risk)

### **3 Technology Risk**

Technology risk is not usually a great concern to lenders for these types of projects. It is not really that important because the technologies being used are well proven.

### **4 Management Risk**

The quality of the government and private sponsor and the operator plus other protection should provide adequate comfort that this risk is being properly dealt with, and then, how other revenues gain to repay the loan - 15 years period pay contract does really need to be structured in such a way or the cost of the project company and other aspects are going to be recaptured so the loan and the equity can be paid back (the equity comes second to the loans)

### **5 Finance Risk**

The water sales rates have been calculated annually based upon the projections for the following year, and these are done in such a way as to insure that the operation and maintenance costs are paid and additional funds are available to amortize the senior loan debt servicing costs (that is interest and principal payment has been paid or the subordinated loan services has been drawn to cover shortfalls). Other funds are then available to take care of the return of the equity and repayment of equity once the debt amortizes. Taxes need to be taken care of as required by law and/or the agreement with the government.

The water sales price is denominated in the respective currency of the obligation of the project company. If you borrow in dollars and have dollars as the source of revenue - fine. If payments are made in Rupiah but at the time when the payments are being made the Rupiah equivalent will need to be adequate to cover all foreign currency payments and, of course, there will be an issue regarding the ability to convert those Rupiahs into dollars.

### **6 Input and Supply Risk**

In water project finance, there is an input supply risk, not like the power plant where the fuel supplies (such as gas or coal) are a very important consideration. Here input and supply risk is covered by the obligation of the various authorities to secure water in order for the water treatment to plan to be effective.

## **7 Market Risk**

Market risk here is covered during whereby basically various costs are going to be taken care of through the setting of the tariff by the government.

## **8 Regulatory and Political Risk**

There is an obligation providing support of the debt. In various cases, including force majeure, this falls under the responsibility of the authorities, but there is also a straight forward government of Turkey guarantee of the take or pay contract, which means that there are three levels of recourse - Project, Municipality and Central Government.

Of course, it is important for banks to be given the ability to have access to the assets and cash flow that the project produces, and there is a need for insurance if the assets get damaged and therefore the project's ability to generate cashflow is adversely effected (insurance will step in). Insurance, of course, is assigned to the bank as well as to all the other rights in the contract, etc - so the lenders get the benefit of the various contractual obligations including insurance (This gives credit worthiness to the project). There are also other types of escrow accounts as well as debt reserves for the future payment of debt if problems arise.

There is a strong importance of acceptance of the obligation by the central government to provide support for water sales payment made by the municipality. The provision of a subordinated loan that the municipality is to be made only on a very limited case basis, nonetheless, the municipality has to assume that the subordinated debt ultimately may have to be paid by the government.

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# PAPER VI

# **Private Participation in Urban Services**

## **PURSE ROUND TABLE SEMINAR**

### **Legal Issues and Institutional Mechanisms That Facilitate Development of Infrastructure Using Public-Private Partnerships**

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I should perhaps offer some explanation for that background. For a number of years I was with another law firm called White and Case, which I suppose all of you know, and was active from 1978 - 1985 on the Government side of the transactions. Since 1989, I have been with another law firm and I have been working on what might be called the foreign bank/foreign developer sides, and at the moment I am acting as legal counsel to the consortium which is developing the Paton Power project.

One of the things about speaking last is usually that the other speakers have already said what you are going to say, so I will still try to find something new to offer as we get to the end of the day.

I just want to talk about legal issues in part of this transaction. As you probably know, legal issues very often get quickly involved with commercial issues, and so that is why we already have talked about this.

The most important thing that we need for this type of project is a legal and regulatory structure that is clear and unambiguous. Let me explain what we mean by that.

In the Paton Project, a problem that we have run into is that the ministerial regulations that regulate private power are inconsistent in a number of respects with the power purchase agreement that we negotiated in that transaction. They were simply inconsistent. Because of that, we are fully anticipating that when we go to the financing stage of the transaction, that the lenders will require, and indeed our investors will require, some action on the part of government to make the transaction that we have negotiated with the government consistent with the regulatory structure. It will be necessary to do that through letters from various ministries clarifying their own regulations. Discussions on those issues is under way and that will be forthcoming. However, I have to say that it is awkward and is not the best way to go about it.

For this reason, as you are working in the next year or so, in considering your approach in privatization and private capital in water and waste water treatment sector, I would seriously consider that you consult with the reputable private development groups concerning the regulations, and get their views on them before they are adopted. I know that it has not been the approach in the past during my experience here in Indonesia. Very often the Indonesian government hires very able advisors, who have been working very hard to develop systems. But when they get to the actual drafting stage, the sector that has been left out are the people who have to ultimately live with them, which in this case is the private sector. Now this

does not detract in any way from the government's sovereign power. This approach is quite common in the United Kingdom and the United States, when proposed regulations are published and those various industries that are going to be affected are able to comment on them both orally and in writing, and the results are often beneficial.

At least in any power projects, one of the things that will come up is the clear right of the private sector to the rights of way, the land, facilities, and importantly to the revenue stream that will provide the return and the repayment to the developers and to the lenders.

In our Patton project, for example, there has been some question as to the actual legal right which PLN has to the site. It is historical that the land was previously owned by the Ministry of Forestry and I will not bore you with details of it, but the situation is such that the status is unclear. But no one is concerned, in a practical way, that we will ever be denied use of the site. But when you go to lenders, and ask to lend a billion eight hundred million of money, they are going to be certain that everything is exactly right. So I think it is something that you want to think about ahead of time, and before you skip half way down the road and find out that you have got a problem, you have to be sure that you have the solution.

When the toll roads were done here, for example, there was a serious question as to who had the right to the tolls, which created problems for the financing because as I am getting to the next point, the lenders and developers want to be sure that they have the first priority over the revenue stream, particularly the lenders. And therefore, it would be important to know that the revenue stream that is the payment stream will pretty much pay off the debts, and will be available on a first priority basis to the lenders and to the project shareholders.

Finally the regulatory structure has to contemplate the fact that lenders will want to take over the project if their borrower, i.e. the project company, is not performing very well and the loan has not been repaid. It is not always clear that the lenders, if they take over, will do a better job, but they at least will insist on the right to have that chance to bring in their own people to finally make the project work, and the structure will need to take into account the fact that the lenders will be able to do that.

The next item is the question of the source of making the payments, we have talked a bit about this already. The lenders, as I mentioned, will want to have the first priority on the revenue stream, and to this end they will want those payments generally made to a some sort of escrow account which is outside of the control either of the borrower or of the parties on the Indonesian side making the payments. This is very simple to accomplish when the

payments are being made to a project company by an authority It will just be more complicated when the private company is delivering services directly to the consumers, and they rely on the consumers for the source of repayment

Let me walk you through this chart quickly, which I would call a generic chart, which does not represent any particular transaction but it is quite a common structure for the private sector (*note see subject chart attached with outline remarks*) Let's start with the lenders on the top They will make loans to what I call PPC, private project company That company will be owned by the developer group, ie the private group, and they will put equity in to some extent - say 25% - and they will borrow loans from the lenders up to 75%

That money comes straight through and drops down to the EPC contractor that is Engineering Procurement Construction, and the EPC contractor will in turn exchange for those payments, they will provide a facility for the private project company The private project company will then enter into, on occasion, not always this way, but an operation and management agreement with an O & M contractor The O & M contractor will provide operation and management services to the project company, in exchange for that it will get paid an operation and management fee In addition, the private project company will have to obtain the utilities that are necessary - water, electric power, you might include here anything, not so relevant for these projects, but any feed stock, any operating consumable it requires

Having received the facilities, the operation and management services and the utilities, the PPC then sell its services to the public authority, which is the water authority or any relevant authority The public authority passes on these services onto the consumers, the consumers pay the authority, then the authority pays the private project company, and then the private project company uses those funds, usually first of all to pay for its operation and management services, then to pay for the utilities

There are many variations on this, and as like I said, it is just a frame of reference for my comments We have already talked a good deal about additional credit support Very often the public authority will not have sufficient credit support to attract the capital of developers or lenders, who are not interested in any kind of risks We will talk about the possibility of local authorities guaranteeing this payment, but that is not sufficient to attract the money from the bank side of developers Mr Williams' paper referred to some other types of arrangement you might want to think of in the future

For example, in the private power projects in Pakistan, they develop the water guarantee board and this might be an organization for example which would be owned by Ministry of Finance (MOF) and operate under the MOF but separately from it. It could be created like Bank Indonesia, which has a charter to extend its lending obligations, and the government will ensure it will be able to meet its obligations, which would probably provide the waiver of necessary credit standing to be acceptable in the lending community. It could be the agency which sort of made the decision as to whether projects were appropriate for this kind of transaction or not. In any event, there are a number of solutions, it is one that is being used in other places and it has a number of things to be set forth - it has been negative and it increases bureaucracies, but if it could in fact be the essential clearing agency for such projects, that could be very useful.

I just want to talk about the nature of the guarantees, you may have done already. In the early stage of Paton there was a long debate as to the difference between a financial guarantee and a guarantee of commercial obligations. I understand it is the Ministry of Finance who is providing a limited credit support in the Paton project. It was comforted by the fact that they were not giving a financial guarantee. It only supports the obligations of PLN - so long as the private developers perform and PLN for some reason would be unable to perform. So the nature of the guarantee is really quite different. That it is not one, for example if the government guarantees the indebtedness of PLN and at the same time did not operate and without faults. In this case, if the Paton private power plant did not operate, that is not the government's problem.

The principal link of between the private group and private authority is what I refer to as resource purchase agreement as in a power purchase agreement, and as in a water sales agreement and so forth. But that is where the focus is on the solution of all these problems.

In terms of pricing I do not know how each transaction is different, but there would ordinarily be a so-called a capacity payment where there is a minimum payment. Provided that the facility is capable of providing the services and providing the resource, so long as it is still capable of doing so, then the public authority in this case will have to make the minimum payment.

What happens, for example if the environmental laws have changed, and therefore the power plant has to be closed because it does not comply any longer with the new environmental regulations? It is no longer, in fact, capable of operating in the meaning of the law. The developer side will certainly want to take the position when there is a change of

environmental regulations, which has prevented its operating In order to solve the problem, there is always be an obligation on the part of the shareholders or developers to try the manage this problem as soon as possible and, of course, money will be spent Of course they will get an adjustment, and we will talk about it later - it will be a tariff adjustment

Another thing is the resource payment and currency fluctuation protection, which we have talked about a good deal Another one which perhaps you have not talked about quite so much is what I call currency convertibility protection Then if you agree that you will pay an amount of Rupiahs, which will then require an amount of foreign currency at any particular time If you have an index of the exchange rate, the normal protection of currency fluctuation, you still have a problem if the country had a genuine convertibility crisis or foreign exchange crisis and, simply, there is not enough foreign exchange to go around This happened in the Phillipines in 1983, and happened in this country in 1965 or about 1966, and the question is what will you do?

One way is to be safe in this type of crisis For example, it is the end of the termination payment, and funds are payable (and while normally maybe payments are in rupiahs), this payment must be made in foreign currency If there is not enough money to go around you are not going to get your foreign currency, but if that payment in the foreign currency is supported by the government credit agency like an Exim Bank, then at least what you have is more or less the same as if you were back lending balance of payments loans to Bank Indonesia

And you are in fact maybe higher on the list, because if you do not get paid you can shut down the facilities presumably, and this is providing needed infrastructure for the society So in any event, it is a problem to think about We have solved the same problem in Paton, not in the way I have mentioned but in a way that is not so different from that, and it is an issue because not withstanding even if foreign investors are prepared to take rupiah risk as part of their exchange The various lending agencies like US Exim Bank, or Japan Exim, and so forth have a very strong view on the problem of convertibility risk

Of course when we talk about this here in Indonesia, Indonesia has had no exchange controls In fact, we have had no exchange control for a long time, and being a dollar based economy because of their gas and oil exports, there has been no serious concern with this But in some of these transactions, for example in Paton, the power purchase agreement in Paton lasts for thirty years, so who knows what may happen over thirty years?

The next item of interest is a tariff "power of adjustment" mechanism. What happens if there is a change of circumstances, for a number of reasons one is environment. Let me just qualify before the PPC tariff. What is paid to the PPC in the diagram is not what the consumers pay to the public authority. But actually what is agreed in the resource purchase agreement to be paid to the PPC for providing services or the capacity.

Why are these projects based on what I call a "captive project"? The investors put their money in and they have no where to go. And I would like give you an example of a shoe manufacturer or bottling company, where, when there are changes they can absorb them by passing on the cost of those changes in their products. Look into at least, capacity component, that component will provide the rate of equity and repayment of their capital cost by way of loans. It is fixed for the life of the transaction, subject only to a tariff adjustment mechanism. So if, for example, the public side defaults on its obligation and causes the project to cost more. For example, you are supposed to provide the site by April 1, and the site is not provided until July 1, or the government is supposed to provide the operating permit by a given date, and simply because of bureaucratic misunderstanding, it is provided six months later. All of these things are going to change the cost arrangement to the developer and he will expect to have his tariffs adjusted in those circumstances.

On the other side, I think, on the government side, they should think about ahead of time, to avoid a particular difficult issue which is the effect of changes in tax laws. Remember that most of these people make their investments especially to authorities on a very careful analysis of the tax implications of the investment. Therefore, if a new tax is enacted or the tax rate is changed and so forth, this can significantly diminish the rate of return on the investment. And therefore, ordinarily, investors and lenders will be looking to a change in their tariff in the event when there is an imposition of the tax law that was not in effect at the time the agreement was reached. As to the tariff, by the same token, I may say that in the event the taxes go down most of the provision for saving. So that if the taxes should change in a more favourable way to the investor, there is a procedure also for reducing the tariffs.

The next item I would like to chat about is "termination". This is a problem because we are talking about important infrastructure for which termination has perhaps more significant consequences than shutting down a manufacturing facility, or generally speaking, what has been agreed in these transaction. If the PPC is not paid by the public authority or if he is dealing directly with consumers, any minimum payment through an arrangement which the

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authority have entered into with them that is not satisfied, ordinarily you have the right to terminate from his side

In those circumstances the public authority, the Indonesian side, would normally be obligated to make a termination payment equal to his anticipated return over the life of the project, discounted back to present value with some agreed discount rate. This can be a sizeable amount.

There are other situations where termination may occur, that is, if force majeure makes the project impracticable. You may have a fire or an explosion or something which just triggers the insurance, that causes all loans to be paid off by the insurance. Basically, if you do not have any source of funding, you have got to really start the transaction all over again.

In those cases, usually there would be a termination. But under those circumstances usually the obligation of the PPC is simply to pay off any debt that was not paid off, or pay an amount to the PPC which will enable to pay off any debt that is not paid by the insurance, and usually to return the actual amount of net present value of the capital to the investor.

In terms of pricing capital structure, it was mentioned, I worked on the standard bid package for Indonesian government, back in 1980 when KEPPRES 14 went into effect. I used to work almost on a daily basis with the Junior Minister name Ginanjar, and the Director Jenderal of BAPPENAS, Saleh Affif. They went on to become Ministers of State, and here I am still talking at seminars. I do not know, but that tells you something about being a lawyer.

At that time, we attempted, in an orderly way, to regularize the bidding package for Indonesian projects. One of the things I want to talk about as the next item on capital structure, as an item which has given us a lot of trouble in the Paiton negotiations. That is, what do you want the investor to bid on, what do you want to include him to cover in his tariff. I think you should think of that well ahead of time. Make them very clear on that before you start, because it will save a lot of heartache. For example, if he is supposed to take the full risks of financing no matter how he is financing his loans ultimately.

Let me step back a minute. Normally, as you know, step one in this transaction is to negotiate the resource purchase agreement. That is the first thing you do. You sit down and negotiate that, and you agree on an amount which an authority will pay the PPC to provide the resource capacity, whatever it may be. Then PPC goes out attempts on the strength of

that contract to arrange financing for the project. Since the price has already been agreed, the PPC then has the risk when he obtains the financing that it will not be within his financial projection to the extent that the interest rates are higher, that the maturity is shorter, that the commitment fees are higher and so forth. It will detract from his return on the transaction. Now he will know that that is one of his risks, and therefore, he will include a contingency for that in his PPC tariff.

You can, from the government side on this, wonder whether this is the best way to approach it. Maybe a better way is to say, we will in fact look at your actual financing and to the extent it was greater than certain projections, maybe we will help you share that risk a little bit. On the other hand, if it is lower than you are anticipating in the projection, maybe you will get some of the benefits.

So, rather than shove the risk back on to him, it may be more advantageous and, the popular term, the least cost approach may be that we share both risk and reward with him to a certain extent. This is something, though, that should be thought about ahead and dealt with in a bid package. If you go that way then you will have a closing, what on the page three I refer to as a "closing date adjustment", when the financing is actually in place then you can make some adjustments. So hopefully, what that would mean is - since the risk was lower, his tariff would be lower to start with.

The next issue is whether Indonesian taxes are going to be included in the price or not. Many first time investors in Indonesia start with the proposition that our price includes no Indonesian taxes. That is only for hardware and software and no taxes. On the other hand, Indonesian government is attempting to regularize the tax system, and so they are tempted to include in the PPC tariff all Indonesian tax burdens as well as all foreign tax burdens, which is a little easier proposition.

Subject to changes, all currently existing taxes, now and again you can ask, I think, is a legitimate and interesting question as to whether that is the least cost approach. Since many foreign investor will not have experience with the Indonesian system, and therefore are likely to include again a contingency in their PPC tariff which may be in excess of the actual tax liability. Therefore it seems perhaps reasonable to consider whether taxes should be a kind of pass through item as they are actually imposed, as far as a water authority is concerned. Since taxes go to the central government, these are not cost of your project, these are transfer payment from the water authority to the central government, and so you can ask, it

seems to me, legitimately speaking, whether the local water authority should be saddled with those tax burdens

For that reason in the U S , I think, as was referred to in Mr Williams' paper, it had been approaches to revenue bonds which are tax free. At least by dealing with the element, when the PPC pays his lenders since they attract no tax on the interest, and lenders may be prepared to lend at a low interest rate. This is quite common and is a way of in effect of reversing the transfer payment I just mentioned. It gives the tax benefit back from the central taxing authority to the local authority.

But I think those are going to be talked about in more detail, as the next year goes on. In any event, the only point I would make is, from the local authority's point of view, it would be most attractive to have the lowest possible tariff, but importantly you need to tell the bidders or the negotiators very early on what the tax status is so they can take that into account.

Finally a related item is the question of flexibility of capital structure for the PPC. I know there has been a talk of a 25% equity contribution and 75% debt. The question is what form does the equity contribution take. It provides flexibility to investors if some of their equity contribution can be in the form of a "subordinated" loan. The subordinated loan means loans that could not be repaid by subordinating the loans from the lenders, but without giving everybody a headache. I mean the effect that is again by having what otherwise be a dividend payable as interest on a subordinated debt, you decrease the net taxable income of the PPC and you increase in effect the withholding on dividend more or less the same as it is on interest, depending on what country you are lending or investing from. In fact, most people move the collected income from Indonesia to the jurisdiction of the investor. However for a number of reasons that provides a way if you going to make him include taxes in his PPC tariff, it is a way to provide him with some flexibility in dealing with that issue.

To get to cost overruns, I think we discussed this a bit earlier, but there are two general issues that fall in the two broad categories. One is those cost overruns which are caused by the performance of PPC and his contractors, and in that case it is his tough luck. He has to pay for those and his return on his equity will suffer because he will have to put up more money than he anticipated. On the other hand you have cost overruns caused by a default of a public authority or by changes of law - environmental laws principally are the ones that you have to be concerned about. Labor laws can effect you a bit, probably not so much. But if you had to reconstruct a major portion of your facility for environmental reasons, that could

be a serious burden. In that case, ordinarily, most everybody agrees that there would be an adjustment on the PPC tariff to account for the unanticipated cost.

The bigger question is how do you pay for those. In many of the lenders' approach to a transaction, they say OK I am prepared to lend a hundred million dollars for this transaction and I am prepared to provide another fifteen million dollars, let's say, for cost overruns. But that is as much as I am going to lend right now, so if we get to the point where the government causes a cost overrun of say twenty five millions dollars, then the developer really has no way of putting out the extra ten million dollars. He may talk to his bank but they may say no, we are just going to take over - you are finished and we will just step in, take over your project, take your equity and the twenty five million and he is gone. The bank comes in and puts up twenty five and takes over the project to get themselves repaid. The developer does not want to find himself in that position.

This, on the other hand, I am telling you about a very sensitive subject in our negotiation. It goes back to the concept of what is the private sector initiatives here. There are this black and white categories - this is private and this is public. In fact, they are mixed, and the the unwillingness of government to participate in situations like this can again increase the PPC tariff to include other contingencies. To the extent that these costs are covered by the developers and the shareholders, and they will get an increase in their tariffs to cover them, that is the extremely expensive way to do it because it has a return of equity in that tariff factor. Whereas you can just go to the public authority which goes out to borrow those money and pays for these costs and all it involves is your actually borrowing the money. I recognize however that this is a sensitive area and I just call attention that it should be dealt with in a practical way. What is best rather than in a way - private versus government.

On construction, the issue is always these transactions where the government or the public authority is going to consider alternative ways to do procurement, in which case it has the right to inspect and control, or rather it is the purchase of capacity. If the latter, in theory it does not care when the project is going to finish - just like when you are buying a water purifier at your local store, you do not know how it is made but you just buy it and it starts working. Generally speaking what you do is to arrive at some sort of a compromise. You do not have the normal inspection and control over the construction that you would if this were a straight procurement. On the other hand I think the government does not want to give up all rights to monitor and see that the thing is proceeding properly.

A question of performance guarantees normally in this type of transaction, if the resource is being sold to the public authority - the public authority normally only has to pay for actual services received. And therefore, this, in fact is a self implementing penalty on the developer. If he does not perform properly because his rate of return is geared very much to performance at proper level, and if he can not perform at that level, he is seriously hurt and therefore, to a certain extent, has to have a performance guarantee.

The same is more or less with the resources sold directly to the consumers, because the consumers are going to pay for what they get. However, you can have a situation where the performance is at a substandard level, then you really do not want to have that developer continue. In that case you should develop an arrangement, where if performance is below a certain level, the government should have the right to terminate and take over the facility. In that case, it is of course possible to include a provision for liquidated damages or performance damages, however you want to call them. As I mentioned, those damages should be in an amount that is reasonably anticipated to permit the public authority to complete the facility if there is an unacceptable delay, or which will cure operating problems if it is a performance failure. Mr. Williams may have given an example where this actually occurred. Take a hundred million dollar project for example, the equity the developer puts up twenty five million dollar and they borrow seventy five million dollars. Now if they are required to pay a hundred twenty five million dollars as liquidated damages and you talk to your engineer and so forth - they will say, you know whatever goes wrong, we are assured that with another twenty five million dollars we can make this thing work right. And that could be the measure of your damages because, remember, you allow the project to enter the hundred twenty five million dollars in efforts that you hope will be worth a hundred million, or at least seventy five million so that at least you are producing enough revenues as you are taking over to pay back the seventy five million dollars in debts. If you are going to go this route it should be made clear that it is the basis on which the bids are being accepted, and on which negotiations are proceeding, from the earliest stage. If it is done, then the developers will be able to assess that properly, and they will be able to pass it on to the PPC construction who is actually going to build the facility.

I think we talked earlier about how you can have liquidated damages secured by a standby letter of credit, or in some countries the same thing is done by bank guarantee. In that case, the issuer of the bank guarantee is taking the credit risk of the developer, but hopefully will ask the support from the PPC contractor for a similar obligation to pay him if the performance is not up to par, or from his O&M contractor if it is a problem of the O&M's poor performance.

Finally I have a couple of other points On insurance, obviously whatever insurance you can have at a reasonable prices in the case of some of these things when you try to get coverage for faulty design and other similar items You can also get insurance to cover performance damages, so called "efficacy coverage" (I do not know where the term comes from) but we have investigated in the Paton situation we found that there is a lot of it in the market Now there may be coverage for projects in a hundred million dollar size, but for projects the size of Paton, we were told that at least in the current insurance market insurance is not available (the insurance market is now its worst shape in the last thirty years and hopefully it is going to get better) But we were told that you can only get four million dollars for what is so called "efficacy coverage" for a single project So it may be acceptable for a project It is not cheap Of course, to the extent the investor is paying for this, the cost is going to be included in his tariff bid

Finally about force majeure and so forth, that is the only important part and it is the issue which gets very sensitive here - is what happens in the case of the so called non-insurable events of force majeure, war, insurrections Even if you have a war coverage, as soon as the war breaks out the insurance will call you up and say that the coverage is cancelled This is quite common Normally you cannot insure against insurrection, and you will say well why? Who cares? But the interesting example of the insurrection effecting the Bangkok toll road raises an interesting point The question is that if this is occurred, does it lead to a tariff adjustment ? The power project in the Phillipines is covered by a force-majeure clause and in our Paton project we have somewhat of a compromise position We have an example with a Mitsui project Many of you may know that it was victimized by the Iran-Iraq war It was bombed repeatedly over the ten year period, and that became the single largest pay-off by the Japanese force majeure insurance program So they are quite sensitive to this so called non-insurable events of force-majeure

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# **Legal Issues in Infrastructure Development and Finance**

Outline of Remarks of  
Raymond W Vickers  
Skadden, Arps, Slate, Meagher & Flom  
New York and Hong Kong  
February 8, 1994

## Outline of Remarks

- 1 Legal/Regulatory Structure
  - Must be clear and unambiguous
  - Need for formal representations and Legal Opinions that transaction is in compliance with all regulations
  - In addition, unless regulatory structure is clear, need clarifying letters from relevant Ministers/Authorities
  - Consider consulting with reputable private development groups concerning regulations before adopting them, this is procedure in US/UK, for example
  - Regulatory structure must permit private ownership or use of rights of way, necessary land and facilities and clear right to revenue stream which provides return/repayment
  - Regulatory structure must permit lenders to the project to take over and attempt to cure problems if the Private Project Company ("PPC") is in default
  
- 2 Source of Return/Repayment
  - Desire to have security of payment
    - Assurance that PPC and its Lenders have first priority on revenue stream
    - Direct payment to escrow account controlled by lenders
  - Additional Credit Support
    - GOI undertaking
    - Water Authority Guarantee Company (?)
  - Minimum Throughput/Usage Agreement
    - Provided Facility performs, this provides assurance of return/repayment
    - Public authorities can effect usage of the Facility through land use (zoning) and other public policy and demographic decisions
  - Protection against environmental shutdown
    - Provides for minimum throughput/usage payment even if Facility shutdown because of a change in environmental regulations
  - Currency Fluctuation Protection
    - Mechanism for payment/adjustment

- Protection to include non-dollars (?)
- Currency Convertibility Protection
  - Procedures in foreign exchange crisis, if any
  - Some international lending agencies say they need "Functional equivalent of loan to Government"
- 3 PPC Tariff adjustment if circumstances change
  - "PPC Tariff" means tariff charged by PPC to public authority or, if relevant, to consumers, as case may be It does not include tariff to consumers if public authority buys the resource from PPC and resells it to consumers
  - Public side defaults in obligations to provide land or equipment or personnel or necessary permits etc
  - Law changes (including environmental law changes) which has effect of increasing costs to PPC or its shareholders
  - Changes in tax laws which impose new taxes on PPC or its shareholders which decrease the return which provided the basis for their investment decision
  - Events of Force Majeure occur which affect PPC's cost structure either temporarily or on a continuing basis
    - Most of these should be covered by insurance, but some are not insurable
- 4 Termination
  - Termination provisions if PPC is not paid or the public authorities are otherwise in default
    - Termination payment equal to discounted anticipated return on the project
  - Termination provisions if Event of Force Majeure makes project impracticable
    - Termination payment equal to pay off of PPC debt and return of capital invested
- 5 Pricing/Capital Structure
  - Make clear from beginning what is to be covered by PPC Tariff —
    - Risk of actual Financing Costs (or other costs) deviating from those projected (?)
      - What is "least cost" approach

- Closing Date adjustment
- Indonesian taxes (?) - income, value added, land use, etc
  - What is "least cost" approach
  - Tax exemptions to provide lower cost to Local Authorities vs decreased GOI tax revenue
  - Protection for actual taxed incurred, rather than include unknown factor in PPC Tariff
- Flexibility of Capital Structure of PPC
  - Use of subordinated debt as part of equity contribution

## 6 Cost Overruns

- Caused by performance of PPC and its contractors - PPC and private developers take this risk
- Caused by defaults of public authority/GOI or changes of law - results in adjustment of PPC Tariff
  - Big Question - who arranges the funding of these costs which have been unanticipated by and are outside the control of PPC and the private developers

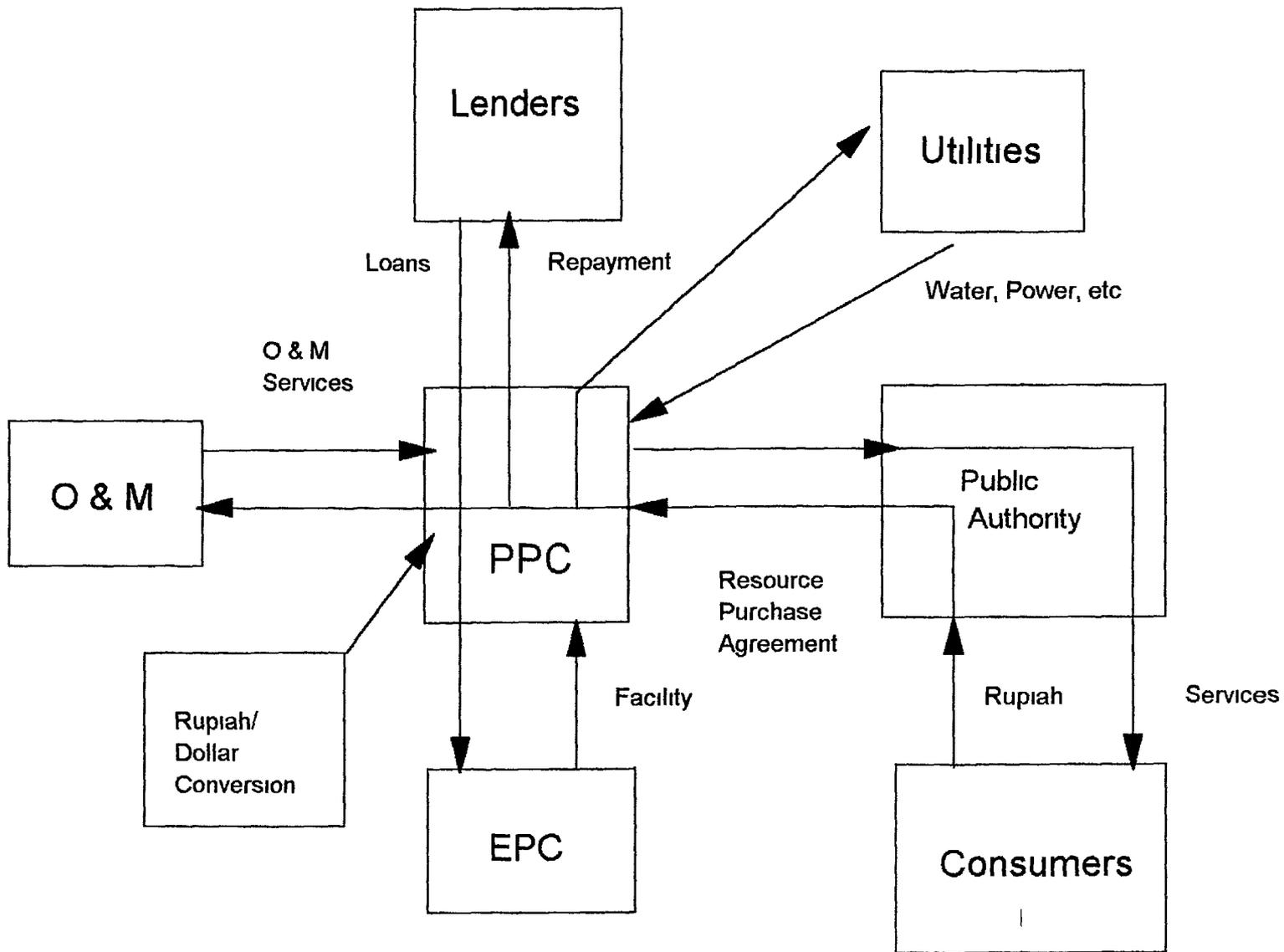
## 7 Construction/Performance Issues

- Is the resource purchase agreement with PPC an alternative to procurement or a purchase of capacity from private sources ?
  - Inspection/monitoring rights
  - "Black box" or normal construction procurement
- Performance "Guarantees"
  - If resource sold to public authority, public authority should have to pay only for actual throughput, in effect, a penalty on PPC for deficient performance
  - If resource sold directly to consumers, then consumers will only pay for what they get
  - In either of foregoing cases, public authority should have the right to terminate PPC (subject to the rights of the lenders to PPC) if performance is below a certain level
  - Also, in case of termination, a provision for damages can be included in

the resource purchase agreement

- Damages should be in amount reasonably anticipated to permit public authority to complete Facility or cure its problems if PPC is terminated for performance failure
- This should be made clear from the beginning so that the private developers can include this risk in their bid for PPC Tariff
- If made clear from beginning, permits private developers to pass on this risk to construction (EPC) companies which actually build the Facility
- Obligations for performance damages can be secured by stand-by letters of credit/bank guarantees
- **Insurance**
  - Insurance should cover all normal perils, such as fire, storm, explosion, etc
  - Consider insurance for business interruption, faulty design and other similar items
  - Consider insurance to cover performance damages, so-called "efficacy" coverage
- **Events of Force Majeure**
  - Which excuse performance
  - Which excuse performance and provide for PPC Tariff adjustment, so-called "non-insurable" Events of Force Majeure

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# ANNEX A

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**13 30 - 14 30**                    **Presentation & Discussion of Private Sector Participation  
Experience in Other Countries**

Speakers                    Mr P D Fyke, Managing Director,  
Project Finance Asia, Chase Investment Bank  
Hongkong

*A Discussion of Key Issues for Financing  
Infrastructure in Indonesia*

Mr Jean-Jacques Poirrier  
Managing Director Environmental  
Project Finance Asia, Chase Investment Bank  
Singapore

*Financing Models for Environmental Infrastructure*

Moderator                    Drs Birong S Tambunan  
Secretary to DitJen PUOD  
Ministry of Home Affairs

**14 30 - 14 15**                    Coffee Break

**14 15 - 15 45**                    **Presentation and Discussion of Private Sector Participation  
Legal Issues**

Speaker                    Mr Raymond W Vickers, Attorney at Law  
Skadden, Arps, Slate, Meagher & Flom  
Hongkong

*PPP/PSP Legal Issues and Institutional  
Mechanisms that Facilitate Development of  
Infrastructure using Public-Private Partnerships*

Moderator                    Dr Ir Budhy Tjahjati S Soegijoko MCP  
Head of Bureau for Urban Development,  
Settlement and Public Housing  
BAPPENAS

**15 45 - 16 30**                    Closing Comments

Speaker                    Dr Ir Budhy Tjahjati S Soegijoko MCP

**16 30 - 17 30**                    Social Hour

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# ANNEX B

**LIST OF PARTICIPANTS FOR PURSE 1ST SEMINAR  
JAKARTA - 8 FEBRUARY 1994**

1 OFFICIALS FROM PUSAT LEVEL

(a) Ministry of Public Works

Drs Soekrisno  
Staff Ahli Menteri VI

Ir Parulian Sidadubar  
Staff Ahli Menteri IV

Ir Hendropranoto Suselo, MPN  
Staff Ahli Menteri I

Ir Djoko Kirmanto, Dpl HE  
Direktur Bina Program, Ditjen Cipta Karya

Ir Tubagus Haedar Ali  
Direktur Tata Kota dan Tata Daerah, Ditjen Cipta Karya

Ir Budiman Arief  
Direktur Air Bersih, Ditjen Cipta Karya

Ir Darmawan Saleh  
Direktur Penyehatan Lingkungan Pemukiman, Ditjen Cipta Karya

Ir Soesanto Mertodiningrat  
Staff Ahli Ditjen Cipta Karya, Ketua Tim Penanaman Modal Swasta

Ir Deka Paranoan  
Kasubdit Persampahan, Ditjen Cipta Karya

Ir Jacob Ruzuar  
Kasubdit Air Limbah, Ditjen Cipta Karya

Ir Ruchyat Deni Dj  
Staf TPK II, Ditjen Cipta Karya

(b) Ministry of Home Affairs (Ditjen PUOD)

Drs Birong S Tambunan  
Sekretaris Ditjen PUOD

Drs Progo Nurdjaman  
Direktur Keuangan Daerah

Drs Rusmana  
Direktur Pembinaan Pendapatan Daerah

Drs Samijono  
Direktur Pembinaan Pemerintahan Kota

Ir H Eddy Kurniadi  
Kasubdit Pembinaan Perusahaan Daerah, Ditjen PUOD

Drs Achmad Samso, MPA  
Kasubdit Bina Penyertaan Modal Daerah

(c) Ministry of Home Affairs (Ditjen Bangda)

Drs H A Nusi  
Direktur Pembinaan Pembangunan Perkotaan

Ir Mulyadi Widodo  
Direktur Pembinaan Program

Ir M Hatta Ahadis MSc  
Kasubdit Bina Kerjasama Pembangunan Antar Kota

(d) Bappenas

Prof Dr Sugijanto Soegijoko  
Deputi V Bidang Regional dan Daerah

Karo P4R  
Dr Ir Budhy Tjahjati S Soegijoko

Ir Pungki Sumadi  
Staff Deputi V/3

(e) Ministry of Finance

Dono Iskandar Ph D  
Kepala Badan Analisa Keuangan & Moneter

Karo Analisa Keuangan Daerah  
Susiyati B Hirawan Ph D

2 REGIONAL AND DKI OFFICIALS

Ir Tb M Rais  
Wagub DKI Bidang Pembangunan

Ir Ery Chajadipura  
Ketua Bappeda DKI

Ir H Syamsul Romli  
Dirut PAM Jaya

Drs Suprpto  
Wagub Jatim Bidang Pembangunan

Ir Kalki Asmorototo  
Dirut PDAB Jatim

Drs H I Hutan Ritonga  
Direktur PDAM Medan

3 WORKING GROUP MEMBERS

(a) PUOD

- Dr Ir Sussongko Suhardjo MSc MPA  
Kasubdit Bina Administrasi Wilayah Kota, Ditjen PUOD
- Ir Gutheng Prabowo MCP  
Kasubdit Tata Wilayah Kota, Ditjen PUOD

(b) Bangda

- Drs M Butarbutar MBA, Kasubdit Bina Kawasan Perkotaan

(c) Cipta Karya

- Ir Toeti Ariati, Kasubdit TPK II
- Ir Rina Agustine, Staff Bina Program PEP

(d) Ministry of Finance

- Busrori, SE, MSc - Kabag Analisa Pembiayaan Urusan Perkotaan

(e) Bappenas

- Ir Bastary Pandji Indra, Staf Deputi V/3

4 MODERATORS

- Dr Ir Budhy Tjahjati S Soegijoko
- Ir Djoko Kirmanto Dpl HE
- Drs Birong S Tambunan

- 5 PURSE TEAM MEMBERS
- Mr C Mark Williams, Chief of Party
  - Mr Michael Conlon, Project Demonstration Advisor
  - Mr Edward Mazuroski, Municipal Services Advisor
  - Mr Anthony Torrens, Urban Economics Advisor
- 6 USAID OFFICIALS
- Mr Timothy Alexander, Project Officer, PURSE Project
  - Mr William Frej, Chief, Urban Management
  - Mr Edi Setianto, Project Manager, PURSE Project
  - Mr Michael Lee, Urban Policy Advisor
  - Mr Philip Tjakranata, Urban Program Analyst
- 7 GUEST SPEAKERS
- Mr Raymond W Vickers, Resident Partner, S A S M & F - Hongkong
  - Mr Paul D Fyke, Managing Director, The Chase Manhattan Bank, NA
  - Mr Jean-Jacques Poirrier, Managing Director, Chase Investment Bank - Singapore
- 8 PRIVATE SECTORS
- Mr Patrick Heininger, Country Manager, PT Waste Management Indonesia
  - Mr James Box, Business Dev Manager, PT Waste Management Indonesia
  - Prof Theodore Parnall, Chief of Party, ELIPS Project
  - Mr Harold Sullivan, Procurement Management Advisor, ELIPS Project
  - Mr B Sungkono Pramono, Director, PT Tirtaatha Buanamulia
  - Dr Michael Croft, Vice President, PT S O R
  - Mr Mark Camstra - Chief of Party, MFP - Price Waterhouse
  - Mr Peter A Neame Ph D - Amdal Advisor
  - Mr Paul L Coutrier - Deputy for Development Bappedal
  - Mr Michael D McNertney, Chemical Bank Indonesia Rep
  - Mr Morgan T McGrath, Vice President, Chase Bank
  - Mr Jay Rossengard, Chief of Party, MFP
  - Ms Mary Boomgard, USAEP
  - Mr J Whittle, USAEP
  - Mr Peter Midgley, Senior Operations Officer, the World Bank
  - Mr George Soraya, Resident Staff, the World Bank
  - Mr K V Kamath, Senior Investment Officer, Asian Development Bank —