



USAID
FROM THE AMERICAN PEOPLE



ENVIRONMENTAL SERVICES PROGRAM

Environmental Services Finance

Indonesia is currently facing an urban water and sanitation crisis, with investment by local government water utilities lagging far behind the pace of development. Current investments in water supply, for example, are estimated at US\$50 million per year. In order to meet Indonesia's Millennium Development Goal of halving the number of people without sustainable access to clean water, however, this amount must dramatically increase to US\$450 million per year. Stated differently, the "financing gap" in the water supply sector alone is currently US\$400 million per year.

USAID's Environmental Services Program promotes better health through improved water resources management and expanded access to clean water and sanitation services. An important aspect of this objective is to address the financing gap that is paralyzing the expansion of water and sanitation services. Specifically, ESP is working to increase access to long-term commercial finance for local governments and their water utilities. Potential alternative sources of financing currently being pursued by ESP and its partners include domestic capital markets and domestic banks.



A Water Treatment Plant in Medan

FOORT BUISTRAAN

Environmental Services Finance team, in addition to increasing access to long-term finance, is also working in the following areas:

- Helping low-income households gain access to piped water supplies through micro-credit loans to cover the high cost of connection;
- Assisting water utilities in the implementation of cost-recovery tariffs and debt restructuring; and
- Raising alternative finance for watershed and biodiversity conservation through 'payment for environmental services' schemes.

ACCESSING LONG-TERM FINANCE THROUGH CAPITAL MARKETS

The greatest need of water utility companies in Indonesia to expand and improve their services is access to long term financing. At present, local government and water utility revenues alone are unable to finance the needed investments. Although commercial banks can provide short-term credit, they are reluctant to extend long-term loans to water utilities. Moreover, central government loans and grants have all but disappeared since the Asian Financial Crisis in the late '90's. Finally, while multi-lateral institutions are willing to extend loans, regulatory and operational uncertainties have complicated the finalization of loan agreements. Given the current regulatory environment, bonds issuance in the domestic capital markets is the most viable source of long term financing.

Central to ESP's strategy to access capital markets is the use of Partial Credit Guarantees (PCGs). PCGs encourage lenders—including banks, institutions, or individuals—to invest in new sectors by reducing risk through a third party guarantee on a portion of the loan. Major donors are increasingly offering PCGs to encourage the financial participation of the private sector. USAID's Development Credit Authority, for example, provides partial guarantees for up to 50 percent of a loan that is backed by the US Treasury. A DCA guarantee can be used to support both direct loans as well as bond issuances.



DANAREKSA

MoU signing on water sector financing between USAID and PT Danareksa.

PROVIDING HOUSEHOLDS WITH THE POWER TO CONNECT

The expansion of water utility services alone does not guarantee increased access to water by individual households, particularly lower income families. There is a very real, upfront connection cost that many families cannot readily afford. To mitigate the connection cost for families, ESP is working with domestic banks and water utilities to establish micro-credit facilities that can provide loans to potential customers who would like to connect but who cannot pay the fixed connection fee in one payment. Once a micro-credit agreement is in place between the utility and the bank, potential customers can obtain loans for up to three million Rupiah (approximately US\$330) for a maximum period of two years. In many cases the utility provides a guarantee to the bank that the loan will be paid off in a timely manner.

IMPROVED FINANCIAL MANGEMENT: FULL COST RECOVERY TARIFFS & DEBT RESTRUCTURING

Two major constraints to the expansion of water utility services are (1) tariffs that do not allow utility's to recover their full costs, and (2) outstanding debts to the central government. Low tariffs and outstanding debt limit the ability of utilities to invest in new infrastructure out of their own cash flow, as well as discouraging potential creditors from providing loans. Regarding improvement of tariff practices, ESP is working with utilities to analyze their revenue requirements, develop a petition to the local government, and increase local support and awareness for the proposed adjustment. As much as possible, ESP encourages utilities to adopt a schedule where tariffs are increased on a regular basis. Concerning overhanging debt, the Ministry of Finance is encouraging water utilities to clean up outstanding debt, and has provided basic guidelines on how utilities are to proceed through this process. ESP is currently working with utilities to prepare the necessary financial documentation to be submitted to the Finance Ministry.

PAYMENTS FOR ENVIRONMENTAL SERVICES

ESP sees 'Payment for Environmental Services' (PES) arrangements as having significant potential in the Indonesian context as pressure on natural ecosystems rises and environmental services previously provided for free become scarcer. A PES may be defined as a voluntary or legally binding transaction where a clear and identifiable environmental service is bought by a buyer from an environmental service provider. Payment is only made if the service is actually provided. Such an arrangement has particular potential in the protection of raw water resources whereby downstream users compensate upstream residents for measures taken to safeguard and improve the watershed. ESP is seeking to implement pilot PES arrangements in watersheds in North Sumatra and Central Java.

ACHIEVEMENTS TO DATE

Among key achievements in ESP's finance portfolio through 2006 are as follows:

- **Indonesia Water Fund.** The Ministry of Finance is highly interested in ESP's plan to develop an Indonesia Water Fund (IWF). The IWF is a mechanism for mobilizing finance for water utilities over a 12-year period. This program will be supported by the USAID's Development Credit Authority as well as other donors. The IWF represents an important step toward commercializing access to credit for the water sector in Indonesia.
- **Water Utility Bond Issuance.** In parallel with the development of the IWF, ESP is working with a credit-worthy water utility and PT Danareksa, a large Indonesian securities firm, in the preparation of a corporate bond to finance the expansion of the utility's service. If successful, the proposed bond issuance will represent the first time a public water utility has accessed long-term financing through Indonesia's domestic capital market.
- **Municipal Bonds.** A clear legal framework is critical for local governments to be able to engage in borrowing on the capital markets. In this regard, ESP is assisting the MOF in the preparation of the implementation guidelines on Municipal Bonds. The guidelines will provide step-by-step instructions on how local governments can access financing through bond issuances.
- **Capital Investment Studies.** ESP has carried out eight Pre-Feasibility Assessments on behalf of PDAMS to evaluate potential capital expansions.
- **Micro-Credit Program.** To enhance the ability of potential water company customers to access the piped water provided by the PDAMS, ESP is working with Bank Rakyat Indonesia (BRI) to develop micro-credit scheme intended for lower income households. The program will include the implementation of formal micro-credit arrangements in 15 cities. Five PDAMS have already signed agreements with local banks.
- **Cost Recovery.** ESP has been advising 10 water utilities on tariff levels needed to achieve reasonable cost recovery tariffs. Five of these utilities have applied tariff increases in 2005/06, ranging from 25% to 74%.
- **Payment for Environmental Services.** Through a small grant, ESP is working with local partner RMI Associates to identify the principles and practices used by local governments to implement voluntary payments for environmental services. The best practices that come out of the study will then be used to guide the implementation of PES arrangements in watersheds in North Sumatra and Central Java.

For more information please contact:

Environmental Services Program

Ratu Plaza Building, 17th Floor

Jl. Jenderal Sudirman No. 9

Jakarta 10270

Phone: +62 21 720-9594

Fax: +62 21 720-4546

www.esp.or.id