USAID FROM THE AMERICAN PEOPLE

ENVIRONMENTAL SERVICES PROGRAM

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Indonesia Water Fund

At present, less than 18 percent of all households in Indonesia have access to piped water. The Government of Indonesia plans to increase coverage to 62 percent in 2015 by increasing the number of household connections from 6.3 million to over 25 million. The required investments are estimated at US$450 million per year, up from the current level of investment amounting to US$50 million per year. Water utilities (or their owners) have not had access to long-term financing since the Asian Crisis (1997) and, as a result, there is a considerable pent-up demand for rehabilitation to existing systems and network expansion.

USAID's Environmental Services Program has proposed a mechanism to finance water, sanitation and related environmental services with third party long-term loans and securitization offerings, referred to as the Indonesia Water Fund (IWF). The IWF is not an investment or infrastructure fund, rather it is a mechanism for financing the capital expenditure requirements of regional water utilities involving a strategic partnership between USAID/ESP, Japanese Bank for International Collaboration (JBIC), Ministry of Finance (MOF) and PT Danareksa, the largest investment bank in Indonesia.

Government formally approved on 29 June 2006 the ESP proposal to implement IWF - although considerable follow-up remains to be done to ensure a successful first trial closing.

FINANCING METHODOLOGY

A primary objective of the arrangements is to mobilize 12-year project finance for the rehabilitation and expansion of water utility networks at affordable and fixed interest rates in local currency.

The mechanism involves the financing of waterworks in two stages:

PARTIES INVOLVED IN IWF

Partners	Role in the IWF
PRIMARY PARTNERS (essential parties to IWF)	
Ministry of Finance	Executing Agency of the IWF, signs loan agreements with
(MoF)	JBIC and PT. Danareksa Finance (JBIC loan proceeds employed to co-finance IWF projects).
PT. Danareksa Sekuritas	Investment house: provides financial advisory and underwriting services to the water utilities.
PT. Danareksa Finance	Co-finances construction loans from MoF loan.
Multilateral and bilateral credit agencies	Issues guarantee to domestic private investors extending 35%-50% cover on exposure taken on operations finance.
Project Originator USAID / ESP	Identifies and analyses prospective projects
JBIC	Extends a Yen loan to GOI (US$50 million equivalent), which is on-lent by MOF to PT. Danareksa Finance for the purpose of co-financing IWF projects.

ESTIMATED INVESTMENT REQUIREMENTS FOR PDAMS WORKING WITH ESP

Institution (PDAM/ PEMDA)	Investment Items	Total Investment (IDR bilion)	Potential New Connections
PDAM Kt. Bogor	System Expansion	46	6,000
PDAM Kb. Bogor (East)	System Expansion, WTP	78	13,000
PDAM Kb. Bogor (Central)	System Expansion, WTP	87.4	11,000
PDAM Kt. Medan	System Expansion, WTP	58	50,000
PDAM Kb. Subang	Bulk Water Supply	30	6,000
PDAM Kb. Subang (Pmkn)	System Expansion, WTP	50	9,000
PDAM Kt. Surakarta	System Expansion, WTP	79	27,000
PDAM Kb. Magelang	System Expansion	35	4,012
PDAM Kb. Bandung	Water Treatment Plant	206	26,000
PDAM Kt. Bandung	Water Treatment Plant	15	66,000
PDAM Kt. Cirebon	System Expansion	158	28,500
PDAM Kt. Cirebon	Bulk Water Supply	122	
PDAM Kt. Malang	System Expansion	46	16,800
PEMDA Kt. Balikpapan	Municipal Bond	120	
Sub Total		**1,265**	**233,312**

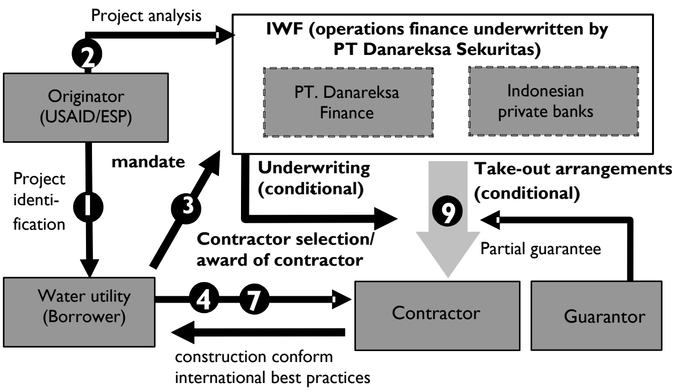
1. Construction of waterworks (for periods up to 2.5 years). At the start of this period, a water utility (the Borrower) and a reputable contractor will agree upon a contract for the construction of waterworks (the Project). The contractor will be responsible for: (i) completing the Project on agreed specifications at fixed-price, fixed-schedule terms;

and (ii) arranging the financing needed to undertake and complete the Project from its own financiers and under its own responsibility. PT Danareksa will be required to provide assurances to the contractor (and its financiers) that a take-out of construction finance is available upon completion of the Project. To provide this level of comfort, PT Danareksa Sekuritas, acting as financial advisor of the borrower, will issue a conditional underwriting of the permanent financing before construction starts (based on initial credit review). The conditional underwriting will be replaced by a formal underwriting before Project completion;

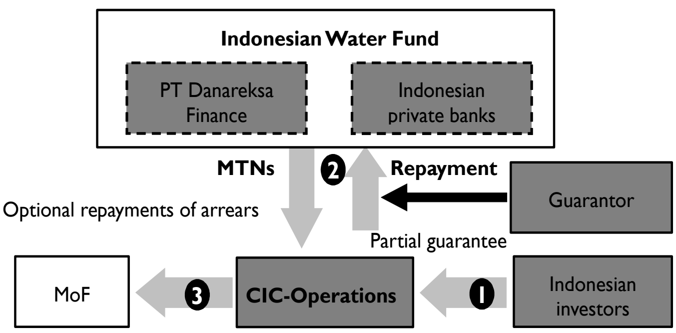
2. Operations (for periods up to 10 years). Three months before the expected date of completion of the Project, a full credit rating of the Borrower will be secured and the take-out of construction financing arranged through an underwriting by PT Danareksa to be made available upon completion of the Project. PT Danareksa Finance will be empowered through formal agreements to make up to 10-year loans to each qualifying water utility, assuming full credit risk.

FINANCING ARRANGEMENTS

Phase 1: Construction.
During this phase, key parties to the proposed financing transactions are USAID/ESP, PT DANAREKSA Sekuritas, PT DANAREKSA Finance, Indonesian private banks and other private financiers, construction contractors, credit rating agencies and water utilities.



Phase 2: Operations (the Bond issue)



SECURITY ARRANGEMENTS

Phase 1: Construction.
Contractor penalties. Upon signing a financing agreement, a Borrower is required to contract reputable company, which is acceptable to the financiers, to construct a water utility network (lenders will be given the right to approve contractors short-listed by the Borrower). Contractors must have a demonstrated track record in constructing water supply systems at internationally acceptable standards on a fixed-price, fixed schedule basis and participate in a competitive tender for the right to build works strictly on fixed-price, fixed-schedule contracts. Finally, contractors must be financially capable to pay penalties for sub-standard performance. These penalties will amount to at least 15% of the contract value.

Phase 2: Operations
Upon completion of the construction of a water supply project, contractor penalties would be replaced by the following set of security arrangements:

- Liquidity standby. A financing agreement with IWF requires the water utility to create a liquidity guarantee with a value of 10 percent of outstanding loan amount before the take-out of the construction financing is effected. The same requirement applies to the owner of the utility (usually a local government)
- Letter of comfort backed by a partial credit guarantee. The letter would state the owner pledges to approve full cost-recovery tariffs including a debt service coverage ratio of at least 1.5; and has a moral obligation to maintain its liquidity guarantee at at least 10 percent of the total borrowed amount from local revenues or national transfers.
- Water utility accounts receivable. In the event that the trustee is required to submit a claim to issuer of the partial credit guarantee, it will be able to access the Borrower's account receivables as a lock-box arrangement.
- Sinking fund requirement. It is envisaged that the straight bond (or the MTNs issued against a CLO bond) will mature at 5,7 and 10 years from take-out with say 30%, 30% and 40% of face value falling due on each of such anniversaries. The precise structure of the maturities would vary by project. To ensure that the Borrower is sufficiently liquid to meet its repayment requirements, the Borrower would require to establish a sinking fund and replenish this fund periodically in accordance with a schedule agreed in the formal underwriting agreement.

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