Asia-Pacific Economic Cooperation

ABAC

# Asia Pacific Infrastructure Partnership (APIP) Dialogue with the Government of Indonesia

22 October 2012 * 2:30 pm – 5:30 pm

Ballroom 3, The Ritz Carlton Jakarta Mega Kuningan, Jakarta, Indonesia

## CONFERENCE REPORT

### BACKGROUND

In 2010, the APEC Business Advisory Council (ABAC) proposed a regional structure to enable governments and the private sector to frankly and objectively discuss complex matters related to infrastructure finance and enhance understanding of the issues and risks they face. This structure, the Asia-Pacific Infrastructure Partnership (APIP), would involve key officials, experts from multilateral development banks, and senior private sector infrastructure experts and practitioners. The APEC Finance Ministers endorsed this proposal at their meeting in Honolulu in 2011. A number of dialogues have been held with various governments – the governments of Mexico and Peru on 24 August 2011 in Lima, the Philippine Government on 5 October 2011 in Manila and the Vietnamese Government on 20 July 2012 in Hanoi.

This dialogue was hosted by the Government of Indonesia on 22 October 2012 at the Ritz Carlton Jakarta Hotel in Mega Kuningan, Jakarta. It was preceded by a preparatory meeting of the APIP panel sponsored by the World Bank and hosted by ABAC Indonesia. The dialogue was attended by key senior officials from the Government of Indonesia led by Vice Minister of Finance Mahendra Siregar, experts from multilateral development institutions and members of the APIP private sector panel. The panel was composed of experts and practitioners representing firms actively involved in infrastructure development from a wide range of industries and perspectives, who offered various reflections on issues from different prisms of the private sector.

As in previous ones, this dialogue with the Government of Indonesia was designed to help address the problem of information asymmetry between public and private sectors. This problem is seen as posing a challenge to closing the gap between the public sector's priorities and aspirations, on the one hand, and the constraints on the private sector's engagement in infrastructure finance, on the other. Through private, frank and open discussions, the dialogue sought to bring these issues to light and to help both the public and private sectors to effectively deal with them while enhancing their collaboration.

### INTRODUCTION

Indonesia has shown marked resilience in the face of recent crises and continuing turmoil in the global economy and financial markets. Even as it confronts fiscal constraints and an uncertain global and regional economic and financial environment, including the more recent slowdown in the region's major emerging markets, Indonesia's economy continues to improve, as manifested recently by the upgrade of its sovereign credit rating to investment grade.

These positive developments have helped increase investors' interest in Indonesia, with its tremendous growth potential, its considerable resources and the opportunities arising from its growing integration with other rapidly growing Asian economies. It is widely acknowledged that the development of infrastructure holds the key to unlocking Indonesia's potential, to the extent that governments at all levels appreciate its importance and as the central government advances further the economy's major reform agenda and democratization. There is strong interest from the private sector to invest in Indonesian infrastructure projects, and Indonesia at this time has a unique opportunity to create the favorable conditions and attractive environment for public-private partnership (PPPs) that will enable the private sector to expand such investments.

Various measures undertaken by government are seen by the private sector as clear signals of Indonesia's commitment to improve the environment for PPPs and the importance of infrastructure for the economy. Recent achievements of the government in putting key building blocks in place include the establishment of key institutions such as the PT Sarana Multi Infrastruktur (SMI), the PT Indonesia Infrastructure Finance (IIF) and the Indonesian Infrastructure Guarantee Fund (IIGF), as well as the development of key performance indicators for projects undertaken by the state electricity company (PLN) and measures to improve its operational performance and to reduce the level of subsidies it receives.

Significant budgetary resources are also being channeled to infrastructure. The 2013 government budget passed by the legislature on the same day the dialogue took place increased the allocation for infrastructure by 25 percent over the current year's budget, which in total was 9 percent higher than the one for 2012. In addition, the government has been able to bring down the government debt to GDP ratio since 2001 from 88 percent to 24 percent. It has been able to achieve progress in strengthening the banking sector and developing the domestic capital market since the Asian financial crisis.

For the Indonesian Government, the APIP dialogue is an important activity, given the centrality of infrastructure in Indonesia's domestic agenda and its special relevance to the economy's 2013 APEC chairmanship. The government sees the dialogue as the first in a series of fruitful interactions with the private sector that is expected to help bring about greater private sector participation in the financing of infrastructure projects in the coming years.

The private sector sees the APIP dialogue as an opportunity to promote a deeper understanding among officials of the great value that investors place on certainty and predictability in the course of their investment and the importance of signaling the government's determination to pursue projects to their conclusion and to focus on key sectors. They also appreciate the opportunity to obtain more information from officials on the project pipeline, the government's priorities and the management processes that are in place to deliver the projects.

## KEY CHALLENGES

### *1. Creating effective institutional arrangements*

The dialogue underscored the importance and urgency of coordination within the government with respect to infrastructure projects. There is no lack of investors to help fill Indonesia's infrastructure needs. Attracting these investors, however, requires a robust project pipeline that in turn depends on the success of efforts to coordinate involvement of multiple line ministries in project preparation. Unless a structure is created that is able to bring all relevant parties together, a significant slowing down of the process leading to financial close of projects will be difficult to avoid.

Coordination among government units at different levels is an important pre-requisite of project readiness. License readiness, which is one of its key aspects, cannot be achieved without aligning the value chain between central and local governments. Another important aspect, physical readiness, also requires close collaboration among agencies. One area where this is particularly crucial is in connection with land acquisition, where infrastructure projects could be speeded up through closer collaboration between the government and the land unit, which can be achieved by measures such as, for example, the establishment of a land bank unit.

Addressing the complexity of decision structures within government that could hamper expanded private sector engagement in PPP projects requires the creation of institutional arrangements that offer sufficient clarity, authority and predictability. An important element of such arrangements is a strong institutional home for the development of well-structured projects. Establishing a strong PPP unit and identifying a "champion" to lead projects and push things forward are possible ways of achieving this. To be able to effectively bring all relevant parties together, however, such units need to have sufficient authority, and preferably legal authority.

The government is aware that there is a need to improve clarity with respect to authority over projects and the operations of existing public utilities, which is a challenging task given the wide range of sectoral ministries, state-owned enterprises and local governments that are involved. To address this challenge, the government is creating a platform for greater cooperation among public utilities and relevant government authorities within the framework of a multi-stakeholder approach, and strengthening units within various ministries to improve coordination and capacities of contracting institutions.

An important measure being taken is the establishment of a PPP unit within the Ministry of Finance, which will be responsible for dealing with the private sector to address their concerns related to the institutional clarity of PPP projects. In pursuing these new arrangements, the government aims to better promote infrastructure projects, whether they be undertaken by the public sector, by the private sector or through PPPs. Noting that a strong PPP unit is an important element of this overall effort, the private sector supports the Ministry of Finance in resolutely proceeding with the establishment of an operational PPP unit.

***2. Strengthening the project preparation process***

A major challenge that follows the completion of a master plan and list of projects is how to make well-prepared proposals that can be offered to the private sector. The private sector's view is that investors and lenders are willing to finance infrastructure even while the process of domestic structural reforms is still ongoing and global market conditions remain difficult, if bankable projects are available on offer that can be consummated in sound contracts and they see a strong commitment by government to engage the private sector in infrastructure development.

From investors' and lenders' perspectives, bankability is a pre-requisite for the success of projects. Being vital to demonstrating bankability, robust project preparation prior to bringing each one to the market is important. At this stage, a strategy that focuses on bringing well-prepared high-quality deals to the market and that results in the successful financial close of a couple of good projects within a year, rather than one focused on quantity of projects, is seen as the most effective for attracting more investors to Indonesia.

This could also go a long way toward shortening the period of time it takes to complete transactions in the case of complex deals. Although other factors such as political complexities and other limitations on the part of government may contribute to extending the time it takes for the process leading to financial close and commercial operations, bringing well-prepared projects to the market, along with more simplified transactions, can significantly shorten the gestation period for these projects.

Strengthening the project preparation process with a view to developing a robust project pipeline will require the provision of adequate budgetary resources, particularly for line ministries to prepare projects to be market-ready and engage qualified transaction advisors. It may also be useful to develop a checklist and an administrative system that could indicate whether a project is ready to be brought out to the market. Management capacity in the government, in particular in contracting agencies, needs to be further developed to more effectively and efficiently bring projects forward to completion. Greater understanding within the public sector of the advantages of harnessing the expertise of outside consultants will also need to be promoted.

The Indonesian Government has taken steps toward this end. The Project Development Facility (PDF) was established to help fund the engagement of projects' feasibility consultants, which represent significant costs that pose challenges to sponsoring agencies' budgets. SMI was created to support adequate project preparation and help government contracting agencies develop internal capacity, in addition to providing long-term financing to catalyze projects. The Ministry of Finance intends to secure more funding from future budgets to promote good project preparation.

***3. Developing local financing sources***

Although there is more than sufficient capital from investors and lenders that can be attracted to Indonesian infrastructure, local financing plays an important role. The availability of long-term local currency funding is especially crucial, and will be dealt with separately in the next section.

Local financing is important for local companies to participate effectively in infrastructure projects and to benefit from the growth of Indonesian infrastructure. Currently, local companies face difficulties in obtaining domestic financing for projects due to the still insufficient capacity of domestic banks and the current regulation on legal lending limits. Local engineering companies, for example, including those which are joint ventures with foreign companies, will need to rely on local financing to undertake infrastructure projects.

Indonesia is currently undertaking various initiatives to improve and adjust the financial regulatory framework, including standards and oversight of the financial system. Among these are the preparations for the establishment of the ASEAN Economic Community in 2015 and the establishment of the new financial services authority that will unify the supervision of various parts of the financial sector. It is important that these efforts are also undertaken with improving the environment for financing infrastructure in mind, such as redesigning regulations, for example, to exempt infrastructure financing from legal lending limits.

***4. Ensuring availability of long-term local currency funding***

In Indonesia, insufficient availability of long-term local-currency funding poses a significant obstacle to expanded private sector engagement in infrastructure. The relatively short lending tenors for infrastructure deals available from local banks, which average around 7-8 years, cannot meet the requirements of financial institutions that are exposed to interest rate fluctuations and need to hedge their cash flows over a longer period of time, typically 20 years or more, when financing infrastructure projects.

Developing the long-term local currency market is not only important for bringing down costs by eliminating the need to hedge foreign exchange risks. It is also important to facilitate greater participation of local banks, operators and other market players and the local economy in the growth of infrastructure projects, which is crucial for maintaining continued political support for private sector financing of infrastructure projects and for enabling Indonesia to develop beyond middle-income status. Addressing this issue today will ensure that Indonesia will be prepared for the next stage of development of its infrastructure, when, in a few years' time, much larger volumes of financing will be required.

The growth of PPPs has often been closely linked to the development of long-term local currency capital markets. In Australia, banks actively developed the market for infrastructure PPP in response to the need of pension funds for suitable places to invest their growing assets. This has driven the broader utilization of the PPP model beyond traditional areas such as roads and energy toward social infrastructure, including education, health care and correctional facilities.

In Indonesia, the local currency bond market can trace its development to the Asian Financial Crisis, which made clear the need to address the currency and maturity mismatch problem that was then common in Asian developing economies. Indonesia has made significant progress since then, and now the domestic capital market provides the dominant share of funding for the government. Indonesia's efforts are supported by ongoing regional initiatives such as the Asian Bond Markets Initiative (ABMI), the Asian Bond Fund (ABF) the ASEAN+3 Bond Market Forum (ABMF), the ASEAN Infrastructure Fund (AIF) and various technical assistance projects.

The government is also working to expand the sources of financing for infrastructure through the capital market by way of having more projects funded through the issuance of Islamic financial instruments such as sukuk. The establishment of SMI and IIF were also undertaken with the goal of helping infrastructure projects in the future gain more access to long-term local currency funding in mind. Indonesia Investment Agency, the sovereign wealth fund, is focused on providing 5- to 10-year financing for local government basic infrastructure, including water utilities, hospitals, roads and transportation, as well as land acquisition for PPP and renewable energy projects.

Multilateral institutions can play an important role in providing long-term local currency funding. Multilateral development banks (MDBs) can provide assistance in structuring financial products for this purpose. In the case of the World Bank, such assistance can be provided for governments that are prepared to work with relevant staff to tailor products that meet their particular needs.

MDBs can also work with foreign financial institutions to issue local currency bonds that can help finance investment in long-term assets, and help attract long-term investors to partner with local institutions in funding infrastructure projects. In the case of ADB, one example is ADB's issuance of local currency bonds in Chinese Taipei and Korea. Another is its effort to attract Dutch pension fund asset manager APG to join the Philippines' Government Service Insurance System (GSIS) in seeding the Philippine Investment Alliance for Infrastructure Fund, together with the Macquarie Group.

Indonesia can significantly benefit from focused efforts to support the development of the long-term local currency market that can provide longer tenors to meet market demands. The recent elevation of Indonesian debt to investment-grade status is a good opportunity for the government to undertake renewed efforts to develop the local sukuk and corporate bond markets.

Through a deepening of pension assets, Indonesia could capture opportunities from the interest of foreign pension funds and investors seeking to partner with significant, established and aligned long-term domestic financial investors, with infrastructure investment in mind, as what APG has done with GSIS in the Philippines. Improvements in balance sheets of institutions in the insurance and pension funds industry are needed, and government officials are now looking into prospects of swapping some of their assets and liabilities with those of commercial banks that continue to hold significant amounts of long-term assets.

The government is aware of the need to update and further develop financial regulations, standards and systems. This can be facilitated through expanded collaboration with the private sector such as through the Asia-Pacific Financial Forum (APFF), a regional platform for public-private sector collaboration in developing the region's financial markets proposed by ABAC, and through the APIP dialogues for discussions directly focused on infrastructure finance.

***5. Improving capacity to mitigate non-commercial risks***

Indonesia can attract more private investment in infrastructure through measures that help address non-commercial risks. The IIGF, which seeks to promote bankability of projects by focusing on how these are structured as well as on process and governance, plays a notable role. The IIGF's capacity to provide credit enhancement could be strengthened through further efforts to optimize available funds that are not currently being utilized, increasing its capitalization, and studying the experiences of other jurisdictions, such as for example with respect to the use of royalties from oil to strengthen the fund. Indonesia is also in the process of establishing a Viability Gap Fund, and a budget for fiscal year 2013 has been set aside.

***6. Developing robust PPP frameworks***

While the government is preparing a number of projects in order to meet the need for sufficient volume and to create a robust project pipeline, much remains to be done to determine which projects would be suitable for financing by state-owned enterprises, by government, by the private sector, or through PPP. As Indonesia looks to promote PPPs in various sectors, it is being challenged by the complexity of infrastructure projects, which requires that the structure of projects and the way to best involve the private sector and allocate risks be carefully adapted to the specific characteristics of each sector.

An example is how to attract private investors to help develop Indonesia's small and medium-sized gas fields, which has proven difficult owing to requirements to dedicate part of production for domestic use at prices lower than those for exports. A way of addressing such a challenge is to take advantage of network effects, for example, through a value-chain approach where upstream and downstream gas activities for power generation are bundled into packages available for bidding, with the regulator setting an indicative tariff that is attractive to the private sector, to facilitate the development of the gas sector as in the case of geothermal power development and to help reduce subsidies to the state electricity company.

This underscores the importance of communication with the private sector and engagement with regional business initiatives such as the APIP in the process of developing PPP frameworks for various sectors.

## CONCLUSIONS

The dialogue underscored the private sector's keen interest in participating in the development of Indonesia's infrastructure, and in being kept informed about the current situation and future directions of infrastructure-related policies. The private sector's expectations focus on a few key issues – greater clarity about the process leading to completion of transactions, how agencies at central and local levels can more effectively work together to develop a robust PPP project pipeline, promoting the availability of local currency finance, particularly with longer term tenors, expanding the capacity to mitigate non-commercial risks and developing robust PPP frameworks adapted to the requirements of different key sectors.

The dialogue also revealed that the most important concerns are shared by government and the private sector. Government officials expressed appreciation for the dialogue, particularly as it provides a platform for officials to directly discuss with private sector representatives of firms engaged in infrastructure development their concerns and to better understand the constraints they face. The dialogue is also seen as providing an opportunity for individual governments to benefit from lessons learned in other economies where there is already substantial experience in infrastructure PPP.

A continuation of direct interactions among government, business and multilateral institutions through the APIP is viewed as contributing to APEC's real achievements in infrastructure finance, which will eventually be measured by the resulting quality and quantity of actual projects on the ground. The Indonesian Government is looking forward to future follow-up dialogues, which may for example include discussions on specific sectors.

The dialogue convinced participants that a stronger collaboration between government and private sector is needed to more effectively meet Indonesia's infrastructure needs. In addition, to ensure that initiatives begun under the Indonesian chairmanship of APEC in 2013 progress to a meaningful level, the Indonesian Ministry of Finance may consider working with the Chinese Finance Ministry and the Philippines' Department of Finance to develop a three-year work program for infrastructure finance under the APEC Finance Ministers' Process.