IPPs are back on the Indonesian government's agenda as part of a broader re-emphasis on infrastructure. But are recent legislative changes and declarations of intent enough to generate a reasonable flow of sustainable deals? By Andrew Kinloch

# IPPs and buts

Indonesia was hit very hard by the Asian economic crisis in 1998 and made little recovery during the post-Suharto Reformasi in 1998–2004. Payment defaults and extended debt rescheduling were typical of the market and have made the international project finance sector wary of Indonesian risk.

However, that perception may be about to change. New government, a stronger economy, new legislation, and huge investment needs are attracting foreign attention – particularly into the power sector. Suppliers scent new customers, investors reasonable returns and financiers, especially overseas ones, attractive yields in a market with the prospect of repeat deals and weak domestic competition.

But the politics remain complicated, land acquisition difficult and the legal framework deficient, indeed exacerbated by moves to decentralize. Consequently international sponsors and financiers need convincing that the Indonesian power sector is a sustainable prospect – a message the new government is striving to get across.

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## PLN domination

State-owned PT Perusahaan Listrik Negara (PLN) dominates generation, transmission and distribution of electrical power in Indonesia and many arms of government have an interest in the entity: PLN is 100% owned by the Ministry of State Owned Enterprises; policy is set by the Ministry of Energy and Mineral Resources (MEMR) and regulated by its Directorate General of Electricity and Energy Utilisation (DGEEU); various decrees are enacted for its benefit by the President or government; its tariffs are set for it by the President and MEMR; credit terms are extended by fellow SOE Pertamina; and the Ministry of Finance underpins its finances.

Aside from various captive plants at mines and factories which do not need to access the grid, PLN as sole holder of the Electricity Authority sells all power in Indonesia, 127GWh of it in 2005, 80% thereof across the Java – Mandura – Bali (Jamali) grid, most of the rest in south and north Sumatra and south Sulawesi with the remaining 13,000 islands barely featuring. Of this, 98GWh came from PLN's own capacity, 26GWh was purchased from IPPs and 3GWh from rented diesel generators.

PLN's own installed capacity of 22.7GW is modest for a population of 245 million and one of the key political measures in Indonesia is the electrification ratio (the proportion of households which are connected to the grid) which in 2005 stood at just 54%. Further, those 22.7GW are spread over more than 1,200 plants. And a ruinous 30% of PLN's generation comes from oil fired capacity or combined cycle plant burning oil: one of the key objectives of the fast track programme (see below) is to reduce this dependence on oil to 5% by 2009.

## A history of IPPs

Of the 26 contracts signed with IPPs between 1994 and 1997, 14 were eventually renegotiated; five were acquired by PLN; and seven terminated. Only Karaha Bodas lingered on, Pertamina ill-advisedly choosing to fight through the courts only to lose when it had assets seized in the US in September of this year. Sponsors on two other deals were paid out under their political risk insurance, others cut and ran. But, of those that reached agreement in renegotiation, the process may have been fraught and slow but the outcome could have been worse in that financiers accepted modestly longer tenors and investors lower, but still positive, returns.

A number of new and old sponsors are still hopeful of reviving several of the projects that were acquired or terminated.

Since the crisis, at the macro level a new electricity law was enacted which was to pave the way for privatization. However, this was annulled by the Constitutional Court. This adds to the air of legal uncertainty in Indonesia. On the upside, however, it keeps PLN as a state-owned/supported offtaker and so actually improves the credit risk for IPPs.

At the micro level, one 2x300MW coal fired IPP, sponsored by Chinese interests, is being commissioned at Cilacap. A second, a 1x600MW coal fired plant at Cirebon, was awarded to a consortium led by Marubeni earlier this year. However, PLN expected bidders to identify the site for Cirebon, with all the uncertainty as to time and cost that that entailed. PLN also unwittingly undersold the extent of MOF support. Subsequent negotiations have therefore been slow.

**PLN capex plans**

PLN has a wide variety of plans for building and financing its capital expenditure, of which the most interesting to overseas financiers will be the IPP programme.

*Fast track programme*

In July, Presidential Decree (Perpres) 71/2006 mandated an accelerated programme by which PLN would procure on an EPC basis some 10GW of coal-fired capacity, much of it to substitute the current oil burning capacity. Ten plants were to be built in Java – Bali for a total of 7GW and 30 much smaller ones elsewhere for 3GW, all by 2009. Although permitted by the Perpres to directly select contractors, PLN has sensibly stuck with competitive bidding. The original timetable was clearly unrealistic and will slip. The ten Java Bali contracts were bid recently: two have now been awarded, four are being evaluated and insufficient bids were received on the remaining four which will therefore be rebid.

PLN intends to finance the fast track programme via buyer/supplier credits from Export Credit Agencies (ECAs). Most shortlisted bidders at the 300MW level were Chinese so these terms will come from Sinosure/China EXIM.

At the 600MW level, in addition to the Chinese, there were Korean, Japanese and other contractors. PLN will use the proceeds from its recent $1 billion bond issue to fund the upfront 15% that it is required to contribute. PLN's repayments over time will be guaranteed by the MOF. Commercial terms/documentation are being developed.

*Direct appointment*

Government Regulation (GR) 3/2005 and GR 26/2006 allow PLN to directly select IPP contractors for effectively almost all its needs. Again, PLN has chosen to stick with competitive bidding for what are likely to be smaller, more local projects.

(The legislative hierarchy in descending order of authority is the Constitution, Laws, Government Regulations, Presidential Decrees (Keppres/Perpres) and Ministerial decrees such as PMK in the case of the Finance Ministry.)

*Legacy IPPs*

Asahan Hydro, Sarulla Geothermal and Tanjung Jati A are just some of the projects dating back to the mid 1990s when MOF comfort letters were originally issued. Negotiations are underway to revive these although there is less need for such comfort letters these days.

*Unsolicited bids*

Unsolicited approaches are permitted although discouraged. These are to be put out to competitive tender with the original proponent being awarded an as yet undetermined advantage in that tender.

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*New IPPs*

Most international financiers' interest will be focused on upcoming IPPs. Bidders recently prequalified for a new round of six IPPs. Of these, the ones attracting most attention were the 2 X 600 MW coal fired Central Java and 1 X 500 MW gas fired Pasaruan.

However, project preparation had been limited and again, not even the site had been identified. At the suggestion of the ADB, PLN has now decided to nominate Central Java and Pasaruan as model projects. This involves going back to properly prepare the project specifications so the bidding phase for these two will be postponed. Ultimately, though, this should result in more transparent bidding on a more definite basis and thus shorter negotiations post award of Preferred Bidder status and better, more sustainable value for money for PLN. Having worked through all processes and negotiated all terms on these two, PLN will be able to use them as templates for further projects, reducing the time necessary to bring these to Financial Close and setting up the pipelist of deals which so many players are looking for.

At least a site has been identified for the Paiton extension (sites 3 and 4) which is to be contested between the two IPPs already on site as PLN's Indonesia Power is now thought unlikely to bid. (Paiton is a crowded site: PLN operates two further plants there and one of the fast track sites is also there.)

Similarly, the plant leased from the Sumitomo consortium at Tanjung Jati B (and therefore, technically not an IPP) will be expanded.

**MOF support for PLN**

PLN has long been seen as insufficiently creditworthy on a standalone basis, partly because of operational inefficiencies but more because of a government tendency to interfere with tariff setting. The extent of government support has therefore always been a crucial issue in Indonesian power. Although the President, as advised by MEMR, still sets tariffs, the MOF's support for PLN has recently been formalized. What is not commonly recognized is how much support this new arrangement gives PLN.

*Fulfilment of Public Service Obligations*

Law 19/2003 and GR45/2005 allow the government to require an SOE to provide a 'function of public benefit'. If this is not financially feasible, the government must compensate the SOE. With its tariffs set for it at below market rates, PLN qualifies and in Minister of Finance Regulation PMK117/PMK02/2005, the MOF sets out how this subsidy to PLN should be calculated.

Crucially, the amount of subsidy is not the difference between the price imposed on PLN and the price it would otherwise have sold at; it is instead the difference (when negative) between the tariff and the total cost of supply for each of a number of different tariff categories. This has the effect of passing all major risks such as deteriorating FX, increased fuel costs or hikes in prices payable to IPPs through to the government. This is why in October, Standard & Poor's and Moody's rated PLN the same as the sovereign, namely BB-/B1 respectively.

Indeed, because the tariff in some categories exceeds cost, i.e. there is no subsidy in that category, PLN actually makes an overall profit from the PSO mechanism. With the politically courageous removal of fuel subsidies and steep increases in world oil prices, the cost of this subsidy has soared to an estimated Rp35 trillion (US$3.8 billion) for 2006. 90% of estimate is paid each month with an annual make up to actual. Cash has flowed from MOF to PLN or debts have been offset on a monthly basis in respect of this subsidy since the beginning of 2006. A margin may be added on pass through which would improve the situation still further although this remains nil until a rate has been agreed.

Some minor costs have not been passed through and there will, no doubt, be further refinements of what may or may not be included. It is not clear, for example, whether unauthorized derivatives losses would be covered. DGEEU may cap the pass through of system losses. Paying the cash to PLN does not guarantee that it will pass it on to its suppliers. The PSO mechanism could be revoked in the future. PMK 117 (which addresses the mechanics of the subsidy, not the obligation to pay it) will need to be extended beyond the current year. All in all, the PSO mechanism is not a full guarantee but it goes a long way in that direction. Most importantly, it shows the government's intent to support PLN.

Secondly, the government is in a much stronger position these days to make good such commitments. In October, Indonesia paid off the last of its IMF debt early. Through the year, Bank Indonesia has gradually cut its key lending rate from 12.75% to a still brutal 9.75% with more expected. Inflation currently stands at 6 – 7%, again down significantly. The Rupiah has recently been relatively stable at about 9,000 to the US$.

The PSO mechanism thus reflects a considerably greater will and ability on the part of the government that PLN meet its debts as they fall due.

*PLN corporate risk*

The PSO mechanism represents support by MOF for PLN as a whole, in all that it does.

PLN's 144A bond issue in September was sold on this basis and, bolstered by the above ratings and some attractive pricing (7.4% for five years, 7.9% for 10 years which was 140bp over comparable sovereign and both of which have since tightened), it raised $1 billion, having received $6 billion in bids.

**In September it signed an umbrella Memorandum of Mutual Understanding with JBIC in which it committed to enable PLN to fulfill its obligations to IPPs by providing compensation for its PSOs (i.e. what its own legislation required it to do anyway); and that any future restructuring of PLN would not impact its ability to pay the IPPs.**

*Additional MOF support*

However, the MOF is moving to give further support in two instances.

First, it will guarantee the supplier credits under the 10GW fast track programme and a MOF decree (PMK) is being drafted to supplement the Perpres.

Second, in September it signed an umbrella Memorandum of Mutual Understanding with JBIC in which it committed to enable PLN to fulfill its obligations to IPPs by providing compensation for its PSOs (i.e. what its own legislation required it to do anyway); and that any future restructuring of PLN would not impact its ability to pay the IPPs. A confirmation letter would be issued, referencing the umbrella agreement to each project involving Japanese sponsors.

The MOF is now working towards a similar understanding with other ECAs such as China EXIM/Sinosure and multilaterals such as the ADB.

Such PSO acknowledgement letters may not carry the same legal standing as the comfort letters from the mid-1990s but, as explained above, the system they acknowledge is a considerably stronger one.

**Remaining hurdles**

Significant issues remain. Acquisition of land and rights of way remain problematic: recent Perpres 36/2005 and 65/2006 still require implementing regulations from the Land Development Agency. Environmental standards need to be addressed. Individual projects need to be seen as part of a coherent whole, i.e. a medium term plan for grid capacity. PLN has been buffeted by corruption charges against senior management and new legislation has deterred its middle management from making decisions either way.

All this notwithstanding, the government's intent is clear and there are greater grounds today for thinking that a flow of well prepared and structured IPPs will eventuate from Indonesia in the medium term. ■

*The views expressed herein are the author's alone. Andrew Kinloch has led project, export and corporate financings for over twenty years in Australia, Europe and Asia with Westpac, Mizuho, UBS and WestLB where he ran Global Structured Finance, Asia Pacific. In 2004, he set up Logie Group, based in Hong Kong, to advise on a wide range of infrastructure finance across Asia. Inter alia, he has been acting as an expert witness on the Manila airport arbitration in front of the World Bank; and he is currently advising the Ministry of Finance in Jakarta on its support for Indonesia's infrastructure plans, especially in the power sector.*
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