B. Case Studies: Umbulan Water Supply System Project in East Java, Indonesia

Despite the limitations just discussed, this does not mean that PPPs cannot be pro-poor. The following looks briefly at how one pro-poor PPP project—the Umbulan Water Supply System Project in East Java Province, Indonesia—is built to provide clean water services to the poor at an affordable price. The project is located in a province where only 75% of the population is served by a water supply system. For the national government, expanding service coverage there was essential to reduce national figures of poverty and inequality.

The Umbulan Project has a long history of development. The initial idea started some 40 years ago, and in 2010 the project was tendered but procured only in 2015. In the beginning of 2016, the Coordinating Minister for Economic Affairs and Chairman of KPPIP led the coordinated efforts, involving Finance Minister, Ministry of Public Works and People's Housing, PT Sarana Multi Infrastruktur (an SOE in infrastructure financing), Province of East Java, and five City and Municipalities. The project is registered as a National Strategic Project and Priority Project.

The project aims to serve 1.3 million people with 93 km of transmission pipe and was estimated to cost Rp2.05 trillion ($143 million). Local governments and a private consortium are only able to finance 60% of the project value. Given the project's importance, the national government decided to make this a showcase PPP, and take necessary actions to make the project financially feasible. PT Sarana Multi Infrastruktur, through Project Development Facility, assisted the East Java Provincial Government to prepare and execute the project transactions. Ministry of Finance provided Rp818 billion ($57 million) through viability gap funding scheme to ensure that water can be accessed by the community at affordable tariff.

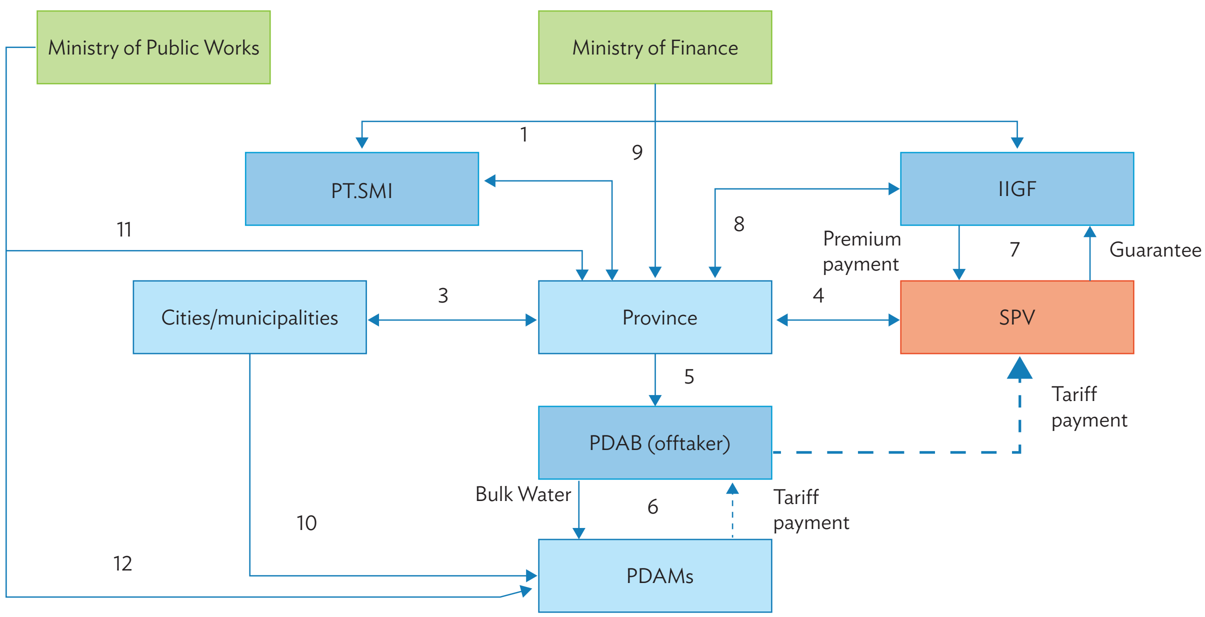
In December 2016, the project financially closed. The current financial scheme is structured to deliver a bankable and fiscally sound project in accordance with prevailing regulations. Part of East Java Provincial Government's commitment is procurement of approximately 7 hectares of land in the Umbulan water source area in 2017 and will continue to acquire the land for the transmission pipes.

The project concession period is determined for 25 years. The planned construction stage will take about 2 years, thus the project is expected to start operation by mid-2019. Revenue stream comes from user fees. Besides fiscal support from the Ministry of Finance, the Indonesia Infrastructure Guarantee Fund, an SOE providing guarantee for contingent liabilities, also provides guarantee to increase the credit enhancement for the implementing business entity or special purpose vehicle. Figure 5 illustrates the transaction schemes among the actors in the project.

The local public water supply company, Perusahaan Daerah Air Minum (PDAM), currently sells clean water at the price of Rp3,331 per cubic meter ($0.25) but cannot meet the demand. Private suppliers sell clean water at the price of Rp36,000 per cubic meter ($2.7) or nearly 11 times PDAM's price. The new price proposal after completion of the Umbulan project is $0.5 or about 20% of current private supply's price. With the new project to service the uncovered poor, the government expects that it will support the welfare and health-care programs.

The Umbulan project shows that coordination under strong leadership can conclude the long delayed process. It also provides an example of the benefits of credit enhancement, provided by the Indonesia Infrastructure Guarantee Fund, and fiscal support through viability gap funding provided by the Ministry of Finance. These schemes are made possible after the government issued Presidential Regulation in 2015, three Minister of Finance regulations, and two Minister of Finance decrees. The successful negotiation led by the Coordinating Minister after the project registered as a National Strategic Project and Priority Project of KPPIP also provides the lessons of the importance of commitment and centered decision-making process. And commitment is hard to secure if the number of projects exceeds the capacity to handle, hence it is essential to provide a credible project pipeline. Credible feasibility study assisted by PT Sarana Multi Infrastruktur contributes to the process of structuring appropriate financial scheme to make the project bankable.

Figure 5: Umbulan Spring Project Transaction Scheme



IIGF = Indonesia Infrastructure Guarantee Fund, PDAB = Regional (Bulk) Water Company, PDAM = Perusahaan Daerah Air Minum (local water company), PT. SMI = Sarana Multi Infrastruktur, SPV = special purpose vehicle.

Notes:

1. Assignment from Finance Minister to PT. SMI to do project preparation
2. Cooperation between provincial government and PT SMI to facilitate project preparation
3. Cooperation between provincial government and municipalities/cities
4. Build-operate-transfer contract between provincial government and SPV
5. Assignment from provincial government to regional water company (PDAB) to become off-taker
6. Bulk water supply contract between PDAB to local water companies (PDAMs)
7. Guarantee agreement between IIGF with SPV
8. Regress agreement between provincial government and IIGF
9. Provide viability gap funding
10. Support from municipalities/cities to PDAMs for bulk water payment
11. Support from the Ministry of Public Works in the form of partial construction, if needed
12. Support from the Ministry of Public Works to PDAMs

Source: Provincial Government of East Java, Republic of Indonesia. 2016. *Mengalirkan Air Umbulan Sejahterakan Masyarakat. Project Profile*. Surabaya.

VI. RECOMMENDATIONS

Although PPP policies across Southeast Asia are at various stages of maturity, the following recommendations to strengthen the policy framework for infrastructure PPPs are offered.

Conducive business environment. Macroeconomic fundamental is vital to attract investment. The countries should strengthen and maintain their macroeconomic stability, fiscal management, sovereign rating, and good governance practice. As the infrastructure industry deals with not only the financial aspects but also the related entities (Figure 4), a good business climate will nurture these components and facilitate efficient markets. This is basic for country development and to become competitive.

Infrastructure financing. PPP is one of the sophisticated financing modalities, which is very different from traditional procurement. It allows bigger participation from the private entity by means of financial structure and engineering, technology and innovation, and risk-sharing schemes. PPP performance is based on service quality and delivery, not on inputs; and contract period is defined by the project life cycle. Consequently, it requires comprehensive understanding and sufficient endowment from the public sector. It also introduces the benefits of market incentives for the public sector. ADB (2017) also emphasized that the PPP feature of risk-sharing creates excellent incentive for the private sector to avoid failure and deliver in a timely and cost-effective manner, high-quality infrastructure and associated services.

Institutions and capacity. Public sector leadership is vital to guide the whole process of PPP. Institutional aspects include legal enforcement, efficient procedures, and effective implementation. All of these require regulatory excellence and expertise from involved public entities. In many cases, it also includes subnational governments and local agencies. In this regard, political economy plays a very important role. The key is to hold vital institutions and strategic officers together to materialize PPP for public benefits.

Project, partner, and process. ADB (2017) summarized the keys of PPP success in these three components. The country shall prepare a suitable and achievable project pipeline, be engaged with a qualified private partner, and institute the right process to ensure that an effective, competitive, and efficient mechanism is in place.

Specific suggestions for tier 1 PPP policy in developing Southeast Asia (Indonesia, Malaysia, the Philippines, and Thailand):

(i) **Good planning and timely execution**. It is better to come up with a few selected prioritized and well-prepared projects that the government has carefully defined than a long list of several projects intended to attract any type of investor that the government does not actually have the capacity to deal with. Management of deal flow is equally important to make investors know what to expect, and to attract the most ready and matching bidders.

(ii) **Technical aspects.** Ensure fair risk-sharing vis-à-vis government support, openness to foreign participation, and hiring of prominent experts to represent government's interests.

(iii) **Innovative financial schemes**. Explore the possibility to improve the value of the project such as using land value capture approach.

(iv) **Capacity building**. Conduct basic level as well as thematic technical skills training for officers with strategic roles in PPPs at both national and subnational levels.

Specific suggestions for tier 2 PPP policy in developing Southeast Asia (Cambodia, the Lao PDR, Myanmar, and Viet Nam):

(i) Focus on building good governance and develop options for infrastructure finance. Understand the importance of transparency and accountability, and set the benchmark for other public institutions on this issue.
(ii) List priority projects. Governments should not provide investors with a shopping list. Showing that the government knows its priority will help organize all possible resources to have similar objectives.
(iii) Mobilize and optimize public resources to support infrastructure. Optimize tax revenue and exercise for government and project bonds.
(iv) Capacity building. Focus on the following key issues: good governance, understanding infrastructure industry, and appropriate regulatory framework.

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