EIBD
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POSITION PAPER

INFRASTRUCTURE & MARITIME LOGISTICS

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SECTOR

INFRASTRUCTURE & MARITIME LOGISTICS

1. OVERVIEW

A new government took office on 20 October 2014. It has confirmed that infrastructure would remain at the centre of Indonesia's economic development, although implementation of the many key projects required is still a major challenge. Regulatory and other bureaucratic issues still hamper progress. As before, insufficient Foreign Direct Investment (FDI) is focused on infrastructure, a matter which has to be addressed by the new government since the amount annually allocated in budget at 2% of GDP is well below that required, which should be as much as 5% or more. The continued reluctance of the previous government to reduce the fuel subsidy has impacted negatively on funding availability and thus on many aspects of the development of the overall economy, and infrastructure in particular.

The current (2014) index on competitiveness put out by the World Economic Forum is shown in Figure 1. This once again highlights the need for very significant infrastructure investment. Lack of infrastructure is a major stumbling block in doing business; logisitics costs are deemed to be the highest in Asia. There is a huge need to streamline bureaucratic procedures although, compared with the 2013 index, improvements over the corruption and bureaucratic efficiency components are indicated. What is particularly highlighted in the 2014 index is deterioration in access to financing, the regulatory structure for foreign currency, and crime and theft.

FIGURE 1

THE MOST PROBLEMATIC FACTORS FOR DOING BUSINESS

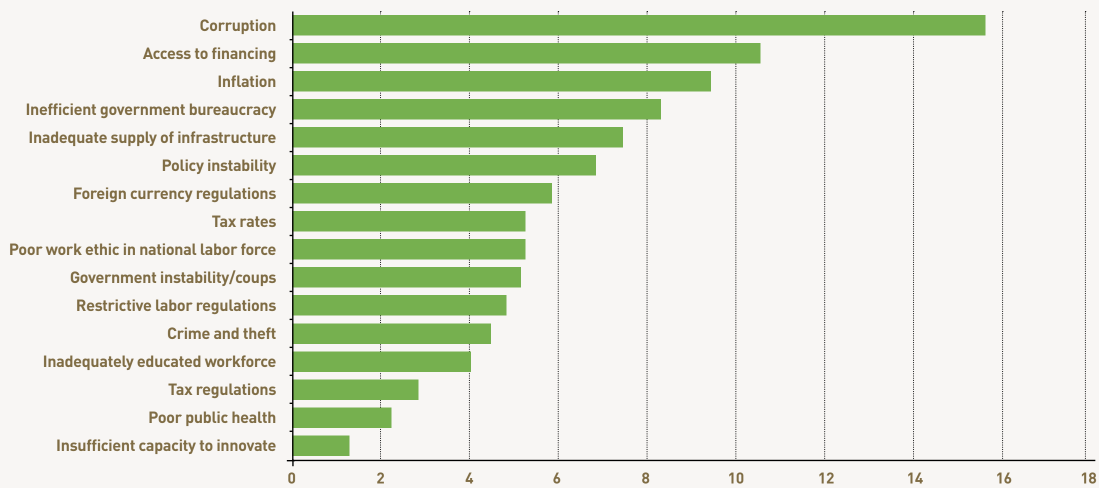


FIGURE 2

INDONESIA RANKING ON INFRASTRUCTURE

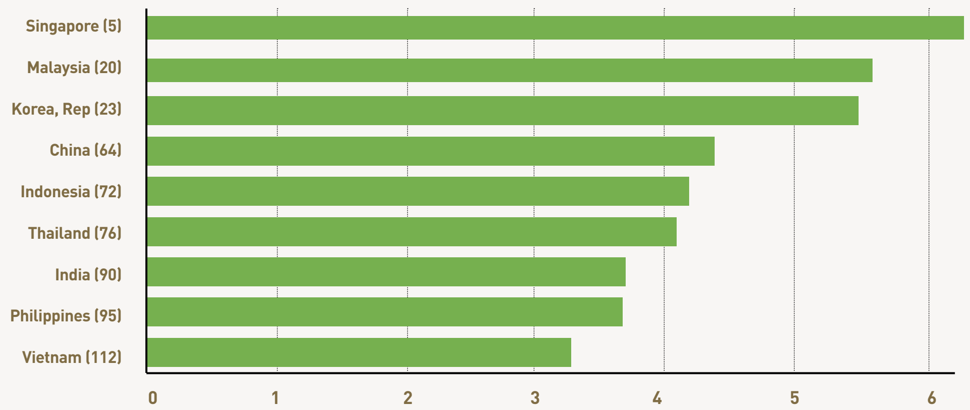


Figure 2 shows the infrastructure ranking of Indonesia compared with other key Asian countries. Its overall position remains below Singapore and Malaysia, but not dissimilar or better than other main ASEAN countries, which overall highlights the considerable effort required to improve infrastructure in all the more underdeveloped countries in the region, notwithstanding the huge infrastructure deficit in India and parts of China.

In Indonesia, the challenge of legal certainty for foreign investors and difficulties over land acquisition for land transport and some key power projects has hampered development. There remains much to be done over land and sea connectivity as well as in airport development. The new government is emphasising port development and domestic connectivity. Considerable investment is required quickly in the electricity sector, with safe margins of supply over demand now at critical levels. Much also remains to be done in the Water Sector to achieve Millennium Development Goals over the next 5-year period, with siginificant inputs from private investment required in both water supply and santitation to boost budget shortfalls.

2. LAND ACQUISITION

Land acquisition, along with availability of funding , public sector capacity and some management skills have continued to be the main obstacles to infrastructure development and hence to improved economic growth resulting from delay in many projects. Very aware of the bottlenecks and the slow reaction to Presidential Law 2/2012 – *Land Procurement for Development Purposes in Public Interest*, the government submitted to parliament a Land Bill in February 2014 with an inventory list of problems. Discussion on the Bill has been taking place throughout the year and has been approaching its final stage. However, on 27 September 2014, both the government and parliament agreed to hold further concluding discussion on this issue into 2015 under the legislative priorities of the new government.

The draft Bill cover issues of land rights, land reform, customary rights, land courts, minimum and maximum limits on land usage, land registration and land that is set aside for social or religious purposes. It is anticipated that, once enacted, the new Bill will define fixed time limits over disputes concerning land to be applied for infrastructure projects, to ensure that acquisition no longer becomes a never-ending obstacle to development.

As before, key toll road projects are continuing to apply previous land regulations. Government is providing support to certain economically needed but otherwise financially unattractive important links, such as the Trans-Sumatra highway, where traffic levels are insufficent to attract private sector investment. Accordingly, signficant central government support is to be provided to get this work off the ground. In October 2014 it announced that it would begin proceeding with four key links of this highway.

3. VIABILITY GAP FUNDING (VGF)

In 2012, through Ministry of Finance regulation No PMK 223/2012 the government launched a new funding initiative to assist projects that were deemed economically feasible but fell short in financial viability terms. The form of the funding support to fill the viability gap would vary according to project. There would be a focus on PPP projects. However, to date although designated for certain projects, e g in the water sector, these have not proceeded to implementation and hence the VGF has not been tried out.

4. INDONESIA INFRASTRUCTURE GUARANTEE FUND (IIGF) AND OTHER RELATED MOF FUNDING STRUCTURES

IIGF was established in late 2009 by the MOF to be the vehicle for PPP projects, which require a performance guarantee for public sector counterparties. Project examples can be found in the power sector, where PLN is the offtaker, or a water project with a municipal water authority or PDAM. IIGF has signed one power sector agreement (yet to reach financial close), but the water projects with which it has been involved have yet to proceed and, in one case, unlikely to do so.

The other sister institutions that have been established by the MOF to help promote long term project financing for infrastructure are Sarana Multi Infrastruktur (SMI), which is wholly owned by the MOF and Indonesia Infrastructure Finance (IIF), which is a private sector NBFI, owned by SMI, IFC, ADB, DEG (KfW Group) and Sumitomo Mitsui Banking Corporation (SMBC).

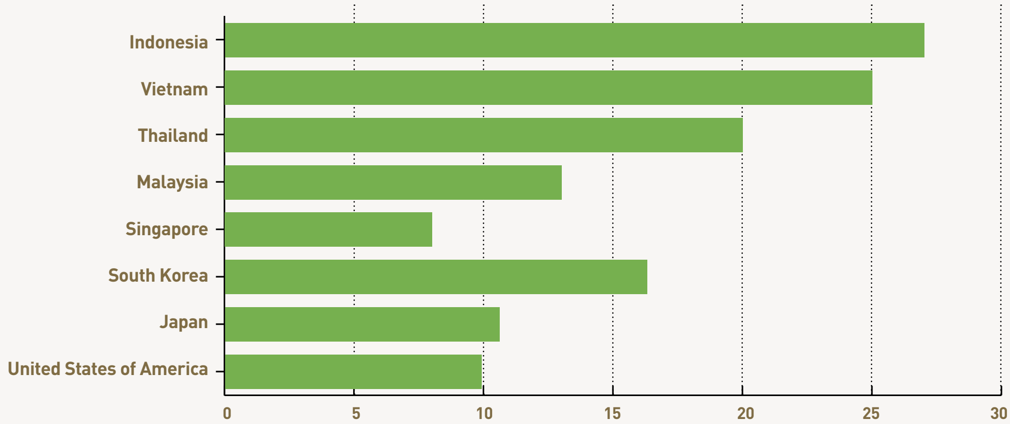
5. TRANSPORT-RELATED INFRASTRUCTURE

Poor sea and land infrastructure has meant that Indonesian business entities have faced higher logistics costs than those of any country in Asia. This is highlighted in Figure 3, based on World Bank data. The lack of infrastructure and the poor quality of much that exists has hindered efforts to develop and realise the national and regional economic potential of the country. Of the costs shown in Figure 3, the largest share is devoted to physical transportation (46%), then inventory (37%) and the balance in administration costs. This is shown in Figure 4.

Looking further into the transportation sector as a whole, Figure 5 (CGI, 2013) shows that the all elements of the sector compare unfavourably with the APEC average and with the more developed of the ASEAN countries. The figure also shows the same trend in electricity provision.

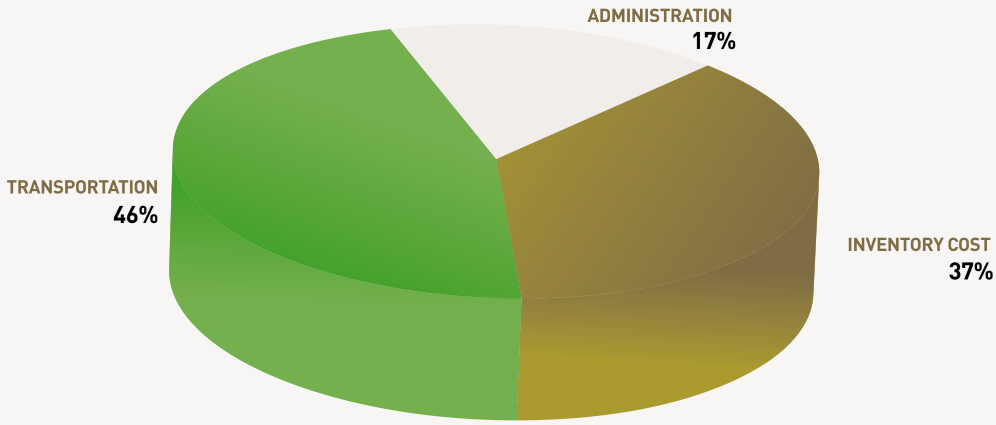
The main development in the ports sector is the ongoing construction of the new large container terminal at Tanjung Priok, called *New Priok*. The first new container terminal is due for completion in early 2015 and commercial operation by the end of 2015. Terminal 2 would be handed over one

FIGURE 3
LOGISTICS COST TO GDP



Source: WB,2013

FIGURE 4
COST COMPOSITION



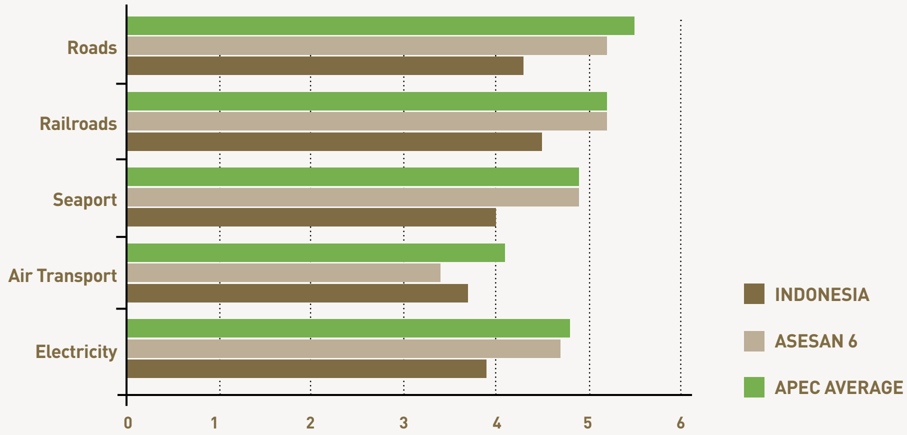
Source: WB,2013

year later and Terminal 3 in early 2018. Little progress over the year has been made in addressing the hinterland needs, however, and construction of these remains on the critical path of the overall development.

Various plans are in hand for the upgrading of the country's other main ports, and there is a serious initiative, the Sea Toll Highway, by the incoming government to link up the archipelago with a series of these main ports following upgrading. It is also planned that the four SOE port operators, Pelindos I – IV, will be merged into one entity, the Indonesian Ports Corporation (IPC). It is considered that the major plans for the maritime sector, including enhancement of the fisheries industry, will provide good opportunities for private sector investment.

With double digit growth in the number of airline passengers travelling likely to continue into the foreseeable future within Indonesia and regionally, there is huge pressure to upgrade and expand the

FIGURE 5
INDONESIA'S SCORE IN RELATED-TRANSPORT INFRASTRUCTURE



country's airports. With the Greater Jakarta area now currently home to some 30 million people, with this to increase to 50 million over the next 30 years, there is an urgent requirement not only to improve the handling capacity of Jakarta's main airport, Soekarno-Hatta, which is now the 8th busiest globally, but to add new airports for the area. As a response to overloading, Jakarta's Halim airport has been brought back into service and is being upgraded to handle 11 million passengers annually. Other plans include a satellite for Sokarno-Hatta, and new airports to the east of the city at Karawang and further east at Kertajati under the purview of the West Java government. The government has also highlighted 10 key regional airports for upgrading and inviting private sector interest to take part in this endeavour. Over 100 smaller airports are also being targeted for upgrading or new construction.

Much work remains to be done to the highway network. Most of this, some 90%, is under regional level jurisdictions and the standards across the country are variable. There is a significant need to not only improve the existing network but also expand it. Indonesia has the lowest road density coverage across Asia. Work has been proceeding on toll roads but the rate of completion of key identified networks will have to accelerate if earlier targets, like having the Trans Java between Jakarta and Surabaya linked by 2018, are to be met. The go ahead for 4 sections of the Trans Sumatran toll road has been recently approved by government, under the auspices of SOEs. However, the sheer high level of traffic growth in the Greater Jakarta area will mean early response to expanding further the current links and those planned but not yet constructed. Without these the current network will soon grind to a halt.

Some improvements have been made to the urban rail network, especially for suburban commuters in the Greater Jakarta area, but considerably more needs to be done, including the construction of overdue additional lines. The rate of work has been too slow. The construction of the long-awaited MRT commenced in 2104 but will not be operational for nearly 6 years. City hall continues to debate the pros and cons of the monorail, although it has been well argued that, with Jakarta having sprung up rapidly over the past 40 years without adequately planned control on development, the monorail offers the only sensible non-road alternative for moving people about the city in the tight spaces left between the congested city street network. Annual losses in fuel due to daily road traffic congestion are huge, the impact on health due to pollution deleterious, and having more commuters travelling on rail systems would mitigate some of these long-term unacceptable problems.

6. WATER SECTOR

Progress in the sector has continued to be slow and previously designated projects under the PPP model and supported by IIGF– the Umbulan (East Java), Bandar Lampung and West Semarang – have made little progress, with the Bandar Lampung project unlikely to proceed. Problems relating to financial viability have shown up and no acceptable resolution using the Viability Gap mechanism has been found.

In 2009 PerPres 29 was issued as a means for sounder PDAMs to access loans from government to upgrade the water supply and distribution systems in their jurisdictions. The terms to which applying PDAMs have had to accede have been nearly always found too onerous such that only a handful of PDAMs to date have been finding the PerPres as a means of assistance. Some other PDAMs have benefited from bilateral aid, but much remains to be done.

Private sector players interested in the sector have been finding it easier to deal directly with local governments that have shown a keenness to improve their service in delivery of water to their populace. A small number of projects has been proceeding along this path, but the overall scale of water provision for the country remains significant. The government has estimated that the investment needed to achieve Millennium Development Goals for water supply over the coming 5 years is in the order of US$ 30 billion with the government budget allocation only being one third of this requirement. For sanitation the respective figures are US$ 35 billion and one half. There is thus some expectation that the private sector will be engaged to fill the gap identified.

7. ELECTRICITY SECTOR

Electricity supply remains at a critical level the safe margin over demand having dropped to a mere few percentage points. Many remoter areas remain without power. A land acquisition dispute has caused a further serious delay in the completion of a 2,000 MW thermal coal power plant in C Java, last scheduled for operation in October 2014. Little progress has been made for minemouth coal power plants in S Sumatra.

Geothermal development, with only 5% of the deemed reserve of 29 GWe of potential so far working, has been mired in a number of difficulties; locations in protected forestry concessions, permit approvals requiring attention from both the Mining department and PLN, local social concerns and an inadequate tariff structure. Improvement to the tariff structure and resolution that in the future geothermal developers would only deal with PLN have reawakened interest in the sector. The government has set a new target for 2025 with planned 9,000 MWe of power provision through geothermal energy. While the target is ambitious, bearing in mind the significant risks that are taken in exploration, the changes tabled by government are seen as a step in the right direction. The large 200 MWe Sarulla project in N Sumatra is now set to proceed.

Some 450 MW of mini-hydro projects have been identified. An improvement in the tariff structure, tabled in 2014, has raised interest in this sector, particularly from private investment, and more projects can be expected to go ahead. Market level tariffs for biomass projects were also issued by the Coordinating Ministry on 16 October 2014 and with better rates for solar projects, the renewable energy sector is expected to gain some momentum in the foreseeable future.

8. ISSUES

- Resolution of remaining legal uncertainty issues
- Terms and application of the upcoming Land Reform Bill
- Review of IIGF and VGF frameworks
- Outstanding overlapping regulations between central and local governments
- Continuing efforts to overcome and minimise the impact of corrupt practices
- Direct appointment of SOEs to undertake selected projects without normal open advertising and opportunity for private sector participation
- Restrictions in certain sectors on foreign investor participation

9. IMPACT

The budget allocation spending for infrastructure is at a very suboptimal level. Furthermore, of the funds allocated too many are given to peripheral services rather than physical infrastructure, and disbursement of funds for many related departments is slow in any fiscal year. Regulations relating to control of the quality of infrastructure built are not adequately enforced. Overall, the continuing lack of progress in project implementation, especially key large projects across all sectors is having a significant negative impact on national growth.

PROPOSED SOLUTIONS

- Continue to address the actions required to address distortions in the economy arising from corrupt practices and accelerate the issuing of effective legal instruments to suport the faster build out of infrastructure.
- Eliminate, as required, fuel subsidies to allow further budget allocation towards infrastructure development.
- As quickly as possible step up the budget allocation of 2% for infrastructure to a minimum level of 5%, as for previous administrations.
- Issue the proposed Land Reform Bill as quickly as possible.
- Empower all appropriate government departments to complete outstanding regulations or streamline where necessary in order that infrastructure projects could proceed more smoothly.
- Review the frameworks for instruments such as IIGF and VGF, which have been established to facilitate infrastructure proejcts, especially through the PPP mechanism, but which so far have had little or no impact.
- Review PerPres 29/2009 for water projects.
- Reassess the frawework of the PPP programme, which has effectively stalled; consider a separate agency for PPP projects.
- Ensure that the focus on SOEs for projects does not impinge adversely on private sector investment, whether domestic or foreign, taking note that the domestic financial market would not be able to support the overall level of funding required to meet infrastructure needs.
- Support the principles set out in the MP3EI 6 Corridor Economic Development Plan and ensure that both levels of regional government, provincial as well as district, improve their performance towards realising a robust level of GDP growth.

WHO SHOULD TAKE ACTION

- Government of Indonesia as the overall owner of projects for national development
- Business community investors and entrepreneurs
- The Indonesian community at large, as the ultimate beneficiaries

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