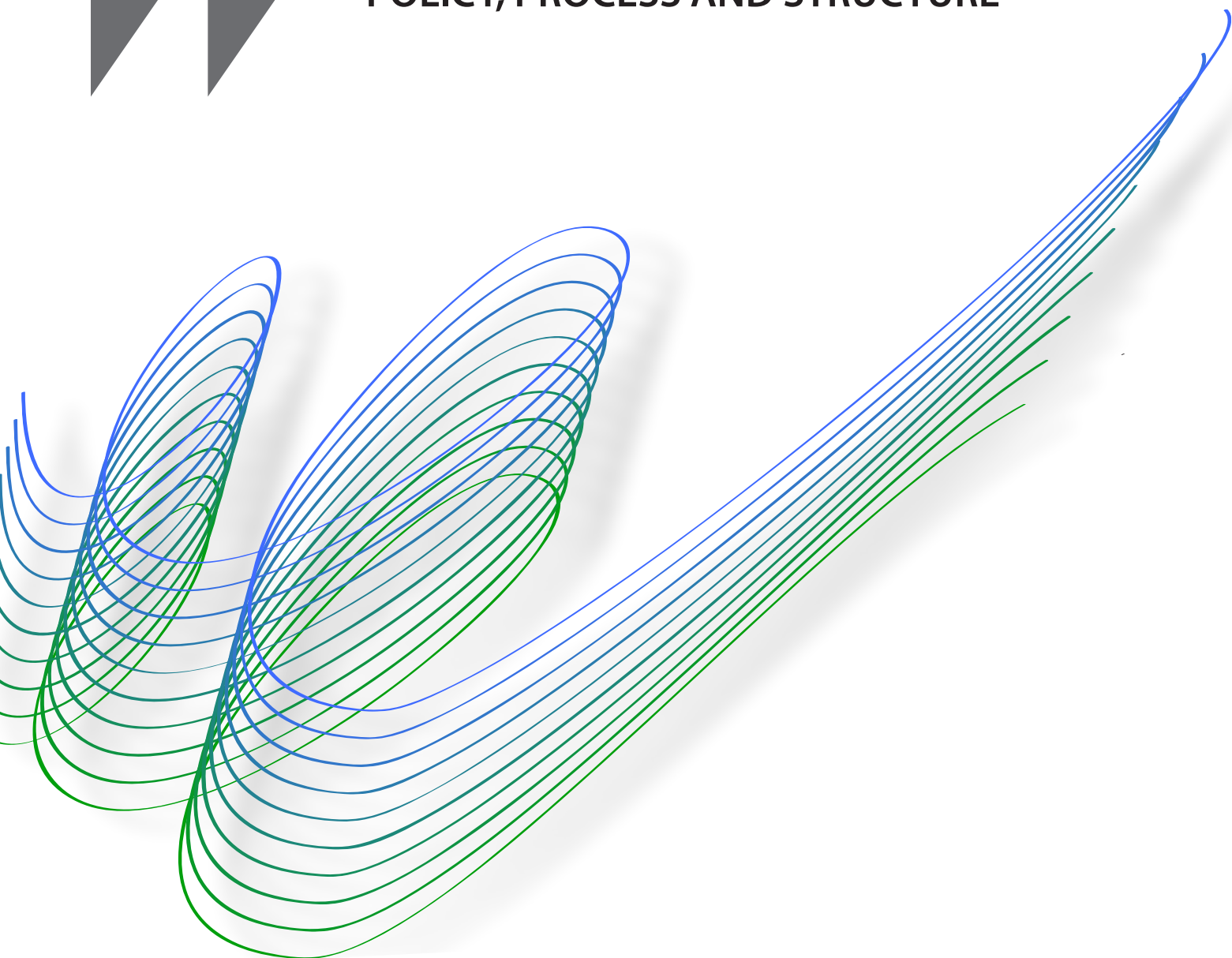




# OECD Reviews of Regulatory Reform

## INDONESIA

### PUBLIC-PRIVATE PARTNERSHIP GOVERNANCE: POLICY, PROCESS AND STRUCTURE



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## *Foreword*

This background report on *Public-private Partnership Governance: Policy, Process and Structure* analyses the institutional set-up and use of policy instruments in Indonesia. It was peer reviewed by the OECD Senior Budget Officials Network on Public-Private Partnerships on 26 March 2012, with the participation of officials of the government of Indonesia, and concludes with policy options for consideration by the government of Indonesia.

The *OECD Review of Regulatory Reform in Indonesia* is one of a series of country reports carried out under the Regulatory Reform Programme of the OECD, in response to the 1997 mandate by OECD Ministers.

Under this programme, the OECD has assessed the regulatory management policies of 24 member countries, as well as Brazil, China and Russia. The reviews aim at assisting governments to improve regulatory quality – that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. The review methodology has developed over two decades of peer learning. It draws on and is grounded in a number of OECD instruments including: the 1995 *Recommendation of the Council of the OECD on Improving the Quality of Government Regulation*; the 2005 *Guiding Principles for Regulatory Quality and Performance*; the 2009 *OECD Recommendation on Competition Assessment*; the 2012 *OECD Recommendation of the Council on Regulatory Policy and Governance*; and the 2012 *OECD Recommendation for Public Governance of Public-Private Partnerships*. This is the first review in this series to be undertaken under the auspices of the OECD Regulatory Policy Committee, which was formed in 2009.

This background report was drafted by Ian Hawkesworth, co-ordinator of the OECD Network of Senior PPP Officials and Philippe Burger, Professor of Economics at the University of the Free State, South Africa.

All background reports of the *OECD Review of Regulatory Reform in Indonesia* are available at [www.oecd.org/regreform/backgroundreports](http://www.oecd.org/regreform/backgroundreports).

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## ABBREVIATIONS AND ACRONYMS

<b>ADB</b>	Asian Development Bank
<b>Bappedas</b>	Regional Planning Agencies
<b>Bappenas</b>	The National Planning Agency
<b>GCAs</b>	Government contracting agencies
<b>IIGF</b>	Indonesian Investment Guarantee Fund
<b>KKPPI</b>	Inter-ministerial committee in principle responsible for co-ordination and the identification of priority projects
<b>LARF</b>	Land Acquisition Revolving Fund
<b>MoF</b>	Ministry of Finance
<b>P3CU</b>	PPP Central Unit, housed in Bappenas
<b>PDAMs</b>	Local government Water SOE
<b>PDF</b>	Project Development Fund
<b>PKPM</b>	Coordinating Investment Board
<b>PT IIFF</b>	Infrastructure Financing Facility
<b>PT SMI</b>	Sarana Multi Infrastruktur, a conduit to channel funds into the PT IIFF
<b>PT. Jasa Marga</b>	SOE for toll roads
<b>RMU</b>	Risk Management Unit in the Ministry of Finance
<b>SOE (PLN)</b>	Power Provider Company

# PPP GOVERNANCE IN INDONESIA: POLICY, PROCESS AND STRUCTURE<sup>1</sup>

## 1. INTRODUCTION

1. Following the Asian crisis Indonesia in the early and mid-2000s embarked on a reform process aimed at revitalising the Indonesian economy. Part of this process involved the implementation of a legal and institutional framework that could serve as basis for a larger degree of private participation in the form of public-private partnerships (PPPs). The legal and institutional framework establishes a basis for the involvement of private participation in infrastructure construction, finance and management. Although the development of the framework has come a long way, the Indonesian government sees the framework as a work in progress and adjusts it to reflect lessons learned through its experience with PPPs.

2. Infrastructure investment as a percentage of government expenditure in Indonesia decreased sharply following the Asian crisis from just below 10% to about 4%. The use of PPPs has not yet enabled the Indonesian government to increase its infrastructure investment. However, the Indonesian government plans to change this through its Master Plan. The Master Plan focuses primarily on increasing the connectivity in Indonesia through among other things the development of six corridors and various ports. In addition Indonesia's 2011-2025 development plan seeks 4,012 trillion rupiah (\$440 billion) of investment, with 1,786 trillion rupiah assigned to items such as highways, harbours and power plants. Through the significantly increased use of PPP in toll roads, rail and power generation the Indonesian government wants to significantly ratchet up infrastructure development, creating the necessary foundation to maintain the high economic growth rates it needs as a frontline emerging market economy intent on joining the BRICS.

3. This chapter first presents a background discussion of what PPPs are and what challenges PPPs pose for the public sector. It then gives an overview of the changing scene for PPPs in Indonesia. This is followed by a discussion on the PPP contract award cycle and the role of the different institutions in the PPP contract award cycle. Based on this overview the challenges that PPPs in Indonesia face as well as possible solutions to these are discussed. This discussion is organised around the three categories of recommendations identified by the OECD that need to inform the procedural and institutional framework as well as the integrity of PPPs. The chapter ends with a number of conclusions and proposals. The OECD Recommendations along with a more detailed discussion regarding value for money are included in appendix to this chapter. A glossary is included as well.

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1. This report was prepared by Ian Hawkesworth and Philippe Burger. Ian Hawkesworth is Co-ordinator of the OECD PPP Network of Senior PPP Officials; Philippe Burger is Professor of Economics at the University of the Free State, South Africa.

## 2. DEFINING PPPS AND THE CHALLENGES AROUND IT

4. Public-Private Partnerships deliver public services both with regards to infrastructure assets (bridges, roads) and social assets (schools, hospitals, prisons and utilities). The interest in PPPs has been growing in recent years across the world and the need for fiscal restraint in some countries is expected to further increase their use. While PPPs can be an effective way to achieve value for money for the public purse they also present policy makers with particular challenges that need to be met with prudent institutional answers. The OECD works towards assisting countries to meet that challenge. Drawing upon lessons learnt by member countries, the OECD has developed recommendations for the institutional and procedural treatment of PPPs, focusing on particular challenges posed to the public authorities in charge of developing, regulating and supervising PPPs and responsible for budgetary discipline and integrity. These recommendations will be discussed further below.

5. There is no widely recognized definition of PPPs. PPPs can be viewed in a broad way as covering most interactions between the private and the public sectors and in a more narrow way as focusing on particular sets of risk-sharing and financial relationships aimed at service delivery. Even when viewed narrowly the stock of PPPs in a number of countries is already substantial and in most countries the number of new PPPs is rising. If used correctly and entrusted with competent authorities, PPPs can deliver value for money, yet under different conditions they can be dangerous for fiscal sustainability due to their complex nature in terms of risk sharing, costing, contract negotiation, affordability, as well as budget and accounting treatment. For instance, OECD research has shown that procurement rules in a number of countries create incentives to prefer PPPs over traditional procurement or vice versa, hindering the capacity of countries to assess adequately the costs and benefits of alternative options and ultimately from attaining the optimum value for money (Burger and Hawkesworth 2011). The same research shows that for some countries the off-budget nature of PPPs, rather than value for money, make them more attractive than traditional procurement of assets regardless of value for money considerations.

6. Public-Private Partnerships can be defined as ways of delivering and funding public services using a capital asset, where project risks are shared over the long term between the public and private sector (see Box 1). A PPP is a contractual agreement between the government and a private partner where the service delivery objectives of the government are intended to be aligned with the profit objectives of the private partner. The effectiveness of the alignment depends on a sufficient and appropriate transfer of risk to the private partners. In a PPP contract, the government specifies the quality and quantity of the service it requires from the private partner. The private partner may be tasked with the design, construction, financing, operation and management of a capital asset required for service delivery as well as the delivery of a service to the government, or to the public, using that asset. A key element is the bundling of the construction and operation and maintenance of the underlying asset over the life of the contract. The private partner will receive either a stream of payments from the government for services provided or at least made available, user charges levied directly on the end users, or a combination of both.

7. This definition excludes a wider array of arrangements where non-governmental organisations such as non-profit civil society groups, trusts, church groups etc. are involved in the development and delivery of public or semi-public services. It includes concession type arrangements where the concession is designed to deliver a public service, but excludes concessions such as licenses to use government assets for example in mining (that are just another way for government to raise revenue). It also excludes traditional public works contracts.



8. If the government is responsible for a stream of payments to the private partner for services delivered, the actual payment for services will likely depend on the private partner's delivery of service and compliance with the contractually set quality and quantity specifications. As a representative of the public interest the government may also establish service standards when PPPs are financed from tolls or user charges. Special purpose vehicles (SPV) often undertake PPPs, acting as the government's private sector counterparty. A SPV is often (but not always) formed by a consortium of companies responsible for the main activities of the public-private partnership.<sup>2</sup>

9. PPPs are sometimes recorded on-budget and sometimes off-budget. When PPPs are undertaken by a SPV acting as the government's private sector counterparty, the impact on the government's accounts will depend on whether the SPV itself is classified as a public or private entity. In many countries, most of these SPVs are created and organized in a way that allows them to be classified outside the central, general, or even the public sector as a whole.

10. Through harnessing the private sector's expertise in combining the design and operation of an asset a PPP can provide the service in a more efficient manner compared to traditional forms of procurement. There are a number of conditions that need to be in place for a PPP to be successful. The most important generic issues are set out in section three below.

#### **Box 1. Different country definitions of public-private partnerships**

There is no widely recognised definition of PPPs and related accounting framework. Eurostat, IASB, IMF, IFRS and others work with different definitions. As illustrated below there is variation between countries.

- **Korea** defines a public-private partnership project as a project to build and operate infrastructure such as road, port, railway, school and environmental facilities – which have traditionally been constructed and run by government funding – with private capital, thus tapping the creativity and efficiency of private sector.
- **South Africa** defines a public-private partnership as a commercial transaction between a government institution and a private partner in which the private party either performs an institutional function on behalf of the institution for a specified or indefinite period, or acquires the use of state property for its own commercial purposes for a specified or indefinite period. The private party receives a benefit for performing the function or by utilizing state property, either by way of compensation from a revenue fund, charges or fees collected by the private party from users or customers of a service provided to them, or a combination of such compensation and such charges or fees.
- The **United Kingdom** defines a public-private partnership as "...arrangements typified by joint working between the public and private sectors. In their broadest sense they can cover all types of collaboration across the private-public sector interface involving collaborative working together and risk sharing to deliver policies, services and infrastructure." (HMT, Infrastructure Procurement: Delivering Long-Term Value, March 2008). The most common type of PPP in the UK is the Private Finance Initiative. A Private Finance Initiative is an arrangement whereby the public sector contracts to purchase services, usually derived from an investment in assets, from the private sector on a long-term basis, often between 15 to 30 years.
- The **State of Victoria (Australia)** defines a public-private partnership as relating to the provision of infrastructure and any related ancillary service which involve private investment or financing, with a present value of payments for a service to be made by the government (and/or by consumers) of more than AUD 10 mil. during the period of a partnership that do not relate to the general procurement of services.

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2. Within the category of public-private partnerships a number of different models exist – which can also give rise to different definitions. These are influenced not only by the responsibilities of the private partner but also the ownership and conceptualisation of the asset.

11. The complexity of PPPs requires a number of capacities in government both in terms of skills, institutional structures and legal framework. There needs to be a robust system of assessing value for money using a prudent public sector comparator (or its equivalent) and transparent and consistent guidelines regarding non-quantifiable elements in the value-for-money judgement. It also involves being able to classify, measure and contractually allocate risk to the party best able to manage it and the ability to monitor the PPP contract through its life. It requires sound accounting and budgeting practises.

## **2.1 Value for Money and the Public Sector Comparator**

12. Governments should assess whether or not a project represents value for money. Indeed, the drive to use PPPs is increasingly premised on the pursuit of value for money (OECD, 2008). Value for money is a relative measure or concept. The starting point for such a calculation is the public sector comparator. A public sector comparator compares the net present cost of bids for the public-private partnership project against the most efficient form of delivery according to a traditionally procured public-sector reference project. The comparator takes into account both the risks that are transferable to a probable private party and those risks that will be retained by government. Thus, the public sector comparator serves as a hypothetical risk-adjusted cost of public delivery of the project. However, ensuring the robustness of a public sector comparator can be difficult and it may be open to manipulation with the purpose of either strengthening or weakening the case for public-private partnerships (e.g. much depends on the discount rate chosen, the value attributed to a risk transferred or whether a cost is front or back loaded).

13. In addition to the quantitative aspects typically included in a hard public sector comparator, value for money includes qualitative aspects and typically involves an element of judgement on the part of government. Value for money can be defined as what government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime. What makes value for money hard to assess at the beginning of a project is that it ultimately depends on a combination of factors working together such as risk transfer, output-based specifications, performance measurement and incentives, competition in and for the market, private sector management expertise and the benefits for end users and society as a whole.

### **Box 2. Accounting for PPPs in the EU**

Originally, the Statistics Office of the European Union (Eurostat) considered that the main issue in classifying a public-private partnership depended on who bears the most risk. The traditional Eurostat view has been that that assets involved in a public-private partnership should be classified outside the government sector if both of the following conditions were met: (i) the private partner bears the construction risk; and (ii) the private partner bears either the availability risk or the demand risk. However, the bearer of risk is not always easy to define, and contract design varies. In cases where it is not possible to classify a public-private partnership as on or off the government books, other contract features can be considered, such as if the asset is supposed to be transferred from the private partner to the government at the end of the contract period and at what price. This event is also an important part of the risk sharing. It should be noted however, that recent guidelines by Eurostat are moving away from the Eurostat decision of 2004. The Eurostat ESA95 Manual on Government Deficit and Debt (MGDD), in its PPP chapter, discusses the considerations that should be analyzed in order to evaluate the distribution of risks between the public and private sector. In particular, if the government provides majority financing, or provides guarantees covering majority financing, it would be an indication of an insufficient risk transfer to the private sector. Moreover, the recent research of Eurostat, in collaboration with the EPEC and EIB ("New developments in PPPs," Financial Accounts Working Group, Eurostat, 2009) highlights the need for revision of these criteria to conform to recent IPSASB guidance (international public sector accounting standards). Eurostat (2004), —New Decision of Eurostat on Deficit and Debt: Treatment of Public-private Partnerships, News Release No. 18, 11 February, The Statistical Office of the European Communities, Luxembourg.

## **2.2 Appropriate Risk Transfer**

14. To ensure that the private partner operates efficiently and delivers value for money, a sufficient, but also appropriate, amount of risk needs to be transferred. In principle risk should be carried by the party best able to manage it. This may mean the party best able to prevent a risk from realising (*ex ante* risk management) or the party best able to deal with the results of realised risk (*ex post* risk management). Some risks can be managed, and are hence called endogenous risks. However, not all risks can be managed and cases may exist where one or more parties to a contract are unable to manage a risk. To those parties such unmanageable risks are exogenous risks (an example is uninsurable force majeure risk that affects all parties, while political and taxation risk is exogenous to the private party and endogenous to government). It should be noted, however, that statutory and political obligations can mean that ultimately the activities of a PPP that fails must be taken over by government. A takeover by the government means that the allocation of risk according to the PPP contract differs from the effective allocation of risk, with the government in effect carrying more risk than allocated to it in the PPP contract.

## **2.3 Contract Negotiating Skills**

15. The ability to write and negotiate PPP contracts are an important public sector capacity requirement, especially given the long-term nature and the large transaction costs associated with PPPs.

## **2.4 Affordability**

16. A project is affordable if government expenditure associated with a project, be it a PPP or other mode of delivery, can be accommodated within the intertemporal budget constraint of the government. A public-private partnership can make a project more affordable if it improves the value for money compared to that realised through traditional public procurement, and then only if the increased value for money causes a project that did not fit into an intertemporal budget constraint of the government under public procurement to do so with a PPP. Some countries are tempted to ignore the affordability issue due to the fact that PPPs may be off-budget (as discussed below). Political considerations may also alter the decisions: due to the political cycle, the policy maker who makes the decision to enter the PPP often does not bear the long-term expenditures involved in the project.

## **2.5 Future Budget Flexibility**

17. A possible difficulty could be that PPPs reduce spending flexibility, and thus potentially allocative efficiency, as spending is locked in for a number of years. Given that capital expenditures in national budgets are often accounted for as an expense when the investment outlay actually occurs, taking the PPP route allows a government to initiate the same amount of investments in one year while recording less expenditure for that same year. On the other hand, the obligation to pay an annual fee will increase expenditures in the future, reducing the scope for new investment in coming years. However, if the PPP represents more value for money compared to traditional procurement, and this saving is not spent up front, the government will have increased its fiscal space in coming years and thus increased flexibility. Government spending might also be affected if the government provides explicit or implicit guarantees to the PPP project and thus incurs contingent liabilities. In some cases concessions and PPPs may also provide a revenue stream to government as part of payment for using existing assets.

## **2.6 Fiscal Impact of PPPs**

18. The system of government budgeting and accounting should provide a clear, transparent and true record of all PPP activities in a manner that will ensure that the accounting treatment itself does not create an incentive to take the PPP route. In some cases systems make it possible to avoid normal spending controls and use public-private partnerships to circumvent spending ceilings and fiscal rules.

19. PPPs should only be undertaken if they represent value for money and are affordable. However, there are those who argue that PPPs should be used to invest in times of fiscal restraint. The fiscal constraint argument for public-private partnerships is driven by pressures on governments to reduce public spending to meet political, legislated and/or treaty-mandated fiscal targets. In parallel with this, many governments face an infrastructure deficit stemming from a variety of factors including a perceived bias against budgeting for capital expenditures in cash-based budgetary systems. However, when responding to fiscal constraints, governments should not bypass value for money and affordability. PPPs may also create future fiscal consequences if they violate the budgetary principle of unity, *i.e.* that all revenues and expenditures should be included in the budget at the same time. Potential projects should be compared against other competing projects and not be considered in isolation to avoid giving priority to the consideration and approval of lower value projects.

### Box 3. The transfer of risks in PPPs

Risks should be carried by the party that manages them best. The key aspect to PPPs is thus identifying and sharing the risks between private and public partners. Three categories of risks, listed in the table below, can be identified: macroeconomic, commercial and legal/ political risks. Risks are events that can be measured and the probability for its occurrence assigned. Risks vary in nature, some of them are endogenous (controllable by a party to a meaningful extent) and some others exogenous, uncontrollable, to at least some of the parties, but measurable.

Risk	Agent	Types of Risk		
		Macroeconomic	Commercial	Legal and Political
External/ Exogenous	Private	Aggregate Demand	Force majeure	Different Investment preferences of alternating governments
		Interest rate risk	Demand risk	Expansionary anti-crises policies raising the cost of financing
		Liquidity risk		Risk of expropriation
		Exchange rate risk		
	Public	Aggregate Demand	Force majeure	
		Interest rate risk		
		Liquidity risk		
		Exchange rate risk		
Project specific/ Endogenous	Private		<b>Project risk</b>	
			Design and construction risk	
			Operation	
			Maintenance	
			Input and output quality and quantity risk	
			Residual value risk	
			Contractor failure risk	
			Renegotiation risk	
			Early termination risk	
			Security risk	
			Technology risk	
			Idiosyncratic interest rate	
			Idiosyncratic liquidity risk	
			<b>Credit risk</b>	
		of the SPV		
		of the constructing and operating		
	of the financial institution			
Public		sovereign risk	Different Investment preferences of alternating governments	
		Demand risk	Expansionary anti-crises policies raising the cost of financing	
			Risk of expropriation	

As a general rule parties are better at managing those risks which are endogenous to them. However, it is difficult to determine a clear list of which risks should be borne by whom as this will often depend on an assessment of the concrete case. Legal/political risks are typically exogenous to the private partner but endogenous to the public partner and therefore are probably better managed by the public side. Macroeconomic risks are exogenous to both private and public partners, but the former could be expected to carry the normal business cycle movements. Demand risk is a type of risk that can be both exogenous and endogenous for the public sector depending on whether the demand is based on end users' preferences or whether it is based on public sector consumption.

Source: P. Burger et al (2009).

20. The OECD surveyed member countries in 2010 about the percentage of public sector infrastructure investment that takes place through PPPs (Burger & Hawkesworth, 2011). Table 1 indicates the percentage of public sector investment that takes place through PPPs and the number of countries to which each range applies. For instance, in 9 of the 20 countries PPPs constitute between 0% and 5% of public sector investment in infrastructure. Furthermore, in 9 countries PPPs constitute between 5% and 15% of total public sector infrastructure expenditure. The stock of PPPs in countries varies significantly. It ranges from one at the federal level in Canada, three each in Norway, Denmark and Austria, to 670 in the UK.<sup>3</sup> In between is France with 330,<sup>4</sup> Korea with 252, Mexico with 200, Germany with 144, Chile with 60, New South Wales with 35, the Netherlands and Hungary each with 9 and Ireland with 8.

**Table 1. What percentage of public sector infrastructure investment takes place through PPPs (2010)?**

Range	N	Country
0% - 5%	9	Austria, Germany, Canada, Denmark, France, Netherlands, Hungary, Norway, Spain
>5% - 10%	7	United Kingdom, Czech Republic, Slovak Republic, Greece, Italy, South Africa, Ireland
>10% - 15%	2	Korea, New South Wales
>20%	2	Mexico, Chile
<b>Total</b>	<b>20</b>	

*Note: No response for the >15% - 20% range.*

21. This section shows that while PPPs are viewed in many countries as an efficient way of delivering public services they also present the public sector with particular challenges. The following section discusses the changing approach to PPPs in Indonesia.

3. The UK count includes only PFIs, and not PPPs falling under a wider definition. For Italy the number excludes approximately 2000 concessions.

4. Excludes concessions, and includes only those PPPs falling under the authority of the PPP unit.

### 3. THE CHANGING SCENE FOR PPPS IN INDONESIA

22. Prior to 2002 decision making in Indonesia was largely centralised. However since 2002 the country experienced a significant degree of decentralisation following the passing of the State Finance Law of 2002. This decentralisation largely entailed the decentralisation of democratic authority and decision-making powers. Government finance still remains largely centralised though. Provinces and local authorities receive an equitable share of national revenue based on a formula for the division of revenue, but local authorities do not really possess a tax base of their own. Since 2010 local authorities can raise property taxes. On local government level there has so far not been much investment expenditure happening, but there are proposals currently that at least 20% of their expenditure should be investment. As discussed further below it is important to note that sub-national government is not obliged to follow central government rules for PPPs. This is only the case if guarantees or fiscal support is sought.

23. There are 490 local governments in Indonesia, each with its own water SOE (PDAMs) and regional bank SOE. Most of the water SOEs are still indebted to the central government, following the serious financial troubles into which these SOEs ran following the Asian financial crisis of 1997. These SOEs are not allowed to borrow money unless they repay their debts to central government, which consequently limits such activity.

24. As part of the decentralisation that occurred since 2002, and in particular in terms of the State Finance Law of 2002, some decision-making power shifted from Bappenas (The National Planning Agency) to the Ministry of Finance (MoF). In addition, decision-making power also shifted to local authorities, which means that the various Bappedas (Regional Planning Agencies) operating on lower tiers of government do not any longer primarily report to Bappenas, but to their respective local authorities. On local authority level Bappenas' role is largely limited to undertaking the promotion of PPP. This is done on its road trips to the various local authorities, followed by an invitation to local authorities and central government ministries to place possible future projects on Bappenas' PPP Book containing potential PPP projects.

25. Before the reform process started in the early 2000s most projects that were not undertaken by the central, provincial or local government themselves were awarded through direct appointment to either SOEs or private firms. As part of the reform process the Indonesian government wanted to improve the process and principles through which projects are awarded. This includes the introduction and use of competitive bidding. As a result Bappenas developed and government introduced Presidential Regulation 67 of 2005. This regulation was improved and augmented further by the introduction of Presidential Regulations 13 of 2010 and 56 of 2011. These regulations regulate what types of projects are considered as infrastructure, what the eligible contracting agencies are and the role of potential private participants. In addition, regulations set out the responsibilities of the Ministry of Finance with respect to the granting of fiscal support and guarantees to specific projects in the procurement process.

26. Since the introduction of the reform and above mentioned Presidential Regulations three Infrastructure Summits were held, the product of which has been a list of possible PPP projects. Many countries seek to kick start a PPP program by nominating a few (a handful) PPP projects based on both national priorities and their chances of success. On the experience of the first handful of projects a more generic approach to PPPs can be developed and rolled out in at national and sub-national level. The first Infrastructure Summit was held in 2005 and resulted in a list of 91 projects. The list increased to 101 potential projects and 10 model projects as part of the second Infrastructure Summit in 2006. By the time of the third Infrastructure Summit in 2010 there were 72 potential PPP projects, 27 priority projects and one ready for offer. However, this rather long list was subsequently shortened substantially so that by the

fourth Infrastructure Summit held in April 2011 there were 5 showcase projects and 11 other projects. Nevertheless, by June 2011 the Bappenas PPP Book 2011 stood at 79 projects of which 45 were potential projects, 21 priority projects and 13 were ready for offer. In addition, contract award went to one project, the Central Java Power Plant (originally part of the 10 model projects identified in the 2006 Infrastructure Summit and signed on 6 October 2011), meaning that this projects is the only project to date to have passed through the project creation cycle specified in terms of the Presidential Regulations 67 of 2005, 13 of 2010 and 56 of 2011.<sup>5</sup>

27. Most, if not all, PPPs in Indonesia are in the form of concession. Four groups of concession can be distinguished:

1. Projects created before the reform process occurred. With regard to roads there are 28 of these projects, 17 of which are concessions awarded to the SOE for toll roads, PT. Jasa Marga, and further 11 concessions awarded to private concessionaires. Some of the later projects awarded to the private sector were awarded following a competitive bid process.
2. Projects signed after the reform process commenced, but still in the pipeline due to process issues, in particular problems with the acquisition of the relevant land. With regard to roads there are 24 of these projects. Some of these concession agreements were signed as far back as 2006. However, because of problems regarding the acquisition of land, none of these projects can proceed. The private partners are responsible for paying for the land, but given that the land acquisition was not finalised when the concession agreements were signed, there is still a large degree of uncertainty about the viability of these projects. Uncertainty exists about whether all the land required for the project will be acquired and at what price it will be acquired. While the new law for expropriation of land for public projects should make this easier, it is still too soon to say with certainty.
3. New projects that are under consideration, not yet signed and therefore are still in the pipeline. These projects will be developed in terms of Presidential Regulations 67 of 2005, 13 of 2010 and 56 of 2011 and therefore will, unlike those mentioned under (2) above, be assessed by the MoF. This assessment may include scrutiny by the Indonesian Investment Guarantee Fund (IIGF) if the project requires a guarantee, or by the Fiscal Risk Unit in the MoF, if the project requires viability gap funding. Currently there are five water projects, two as potential PPPs and three as ready-to-offer PPPs, under this category.
4. New projects that are signed and project award occurred. Only one such project exists, namely the Central Java Power Plant. This project went through the process set out in Presidential Regulations 67 of 2005, 13 of 2010 and 56 of 2011 and received an IIGF guarantee.

28. To establish the possible reasons why the Indonesian government selects PPPs over traditionally procured infrastructure, a questionnaire was circulated to the Indonesian MoF. The MoF was presented with a list of features that might either render a PPP more attractive than a traditionally procured infrastructure or vice versa. The results are presented in Tables 2 and 3. Factors that cause the government to prefer PPPs to traditional infrastructure procurement include that the projects generates debt that is not on the balance sheet of government, as well as factors relating to skills. Factors that cause the government to prefer traditional infrastructure procurement to PPPs include projects that are politically or strategically important and projects that require skills that are more available in the public sector than in the private sector. The reasons listed making PPPs or traditional infrastructure procurement attractive are similar to

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5. The Central Java Power Plant cost about IDR 30 trillion (20-30% equity of which 60% will be provided by Japanese investors, 70-80% debt, including foreign investment).

those found in OECD Countries (Burger and Hawkesworth 2011). Apart from the balance sheet incentive they are sound and reflect accepted knowledge regarding the strength and weaknesses regarding PPPs.

**Table 2. Do the following make PPPs more attractive in comparison to traditional infrastructure procurement?**

	<b>Y</b>	<b>N</b>	<b>S</b>
The project generates debt that is not on the balance sheet of government	X		
The project requires high level of constant maintenance			X
The project requires a high level of service delivery performance	X		
The project requires skills that are more readily available in the private sector, compared to the public sector	X		
Strong Public Unions in the public sector in the relevant sector			X

*Legend: Y: Yes, N: No, S: Sometimes*

**Table 3. Do the following make traditional infrastructure procurement more attractive in comparison to PPPs?**

	<b>Y</b>	<b>N</b>	<b>S</b>
The project is politically/strategically important (e.g. defence)	X		
The project is complex in management and design		X	
The project risk is difficult to quantify and measure (e.g. large IT investments)			X
The project requires a high level of maintenance			X
The project requires a high level of service delivery performance			X
The project requires skills that are more readily available in the public sector, compared to the private sector	X		
Strong Public Unions in the public sector in the relevant sector			X

*Legend: Y: Yes, N: No, S: Sometimes*



#### 4. THE PPP CONTRACT AWARD CYCLE AND THE ROLE OF THE DIFFERENT INSTITUTIONS IN INDONESIA

29. This section sets out the roles of the different institutions involved in setting up a PPP in Indonesia. In Indonesia the government contracting agencies (GCAs) can be ministries, provincial authorities, as well as local authorities. In addition, PLN, the power SOE, also acts as a GCA.

30. As mentioned above, Presidential Regulations 67 of 2005, 13 of 2010 and 56 of 2011 regulate the creation of PPPs. In principle GCAs are free *not* to comply with these three presidential regulations and they do have the authority to conclude their own contract. However, should the GCA require a government guarantee or fiscal support for its project, it needs to submit the project to the MoF and comply with the three regulations. Since international banks increasingly expect a government guarantee, it is becoming increasingly difficult to engage in PPP contracts without either fiscal support or a government guarantee. Therefore, GCAs submit most new projects to the three presidential regulations and hence the scrutiny of the Risk Management Unit (RMU) of the MoF. Answering to the RMU the IIGF performs a key role in screening projects – indeed, its role comes closest to the gatekeeping role played by MoF in the UK, South African and New South Wales and PIMAC in Korea. The RMU also intends to follow a single-window policy whereby the IIGF performs the full project evaluation and assessment for the MoF. The IIGF operates within the terms set out in Government Regulation 35 of 2009.

31. Should a guarantee be required the GCA should obtain it from the IIGF prior to the bid taking place. The IIGF evaluates the project in terms of its economic/financial, technical and environmental viability. Only if it is satisfied by the evaluation will the IIGF extend a guarantee – thereby effectively green-lighting the project and thus effectively serving a key gatekeeping role. The IIGF will subsequently conclude a guarantee agreement with the winning bidder and a recourse agreement with the GCA. Though the IIGF's own capital is limited, co-guarantors and a World Bank standby facility of approximately US\$480 million backstop it. In the final instance government, through the MoF can also increase its capital or give a guarantee to specific projects. Currently the IIGF is reviewing three projects (a water project, a rail road project and a toll road project) and has extended a guarantee to only one project, the Central Java Power Plant mentioned above.

32. The IIGF, answering to the RMU, also considers the risk-sharing arrangement of the contracts. It is willing to guarantee political risk, performance risk<sup>6</sup> and demand risk, which if mitigated, leaves availability risk as the one risk that should spur the private partner to being efficient. By having the IIGF undertake all the guarantees the MoF attempts to ring fence the amount of risk to which the government is exposed. Nevertheless the RMU notes that should the IIGF land into financial trouble, the government will support it. Thus, though the risk to which the government is exposed is ring-fenced in principle, it might not turn out so in practice.

33. In addition to the evaluation and screening roles of the RMU and the IIGF, there is also Coordinating Investment Board (PKPM), which is mainly responsible for the marketing of PPPs to possible foreign and domestic investors. The PKPM operates on the basis of an MoU between the Ministry of Economy, MoF and Bappenas.

34. Two institutions focus on the financing and in particular the viability gap funding of projects whilst answering to the RMU. These are the Indonesian Infrastructure Financing Facility (PT IIFF) and Sarana Multi Infrastruktur (PT SMI). The PT SMI operates in terms of Government Regulation 75 of 2008

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6. The risks that the completed project does not perform as intended.

and is a conduit to channel funds into the PT IIFF, which is a private entity in which the World Bank, the IFC, Asian Development Bank, KfW and DEG hold shares. The intention is also to bring in more private banks as shareholders of the PT SMI. The PT SMI provides local financing complimentary to that of the international banks. In essence it implements viability gap funding where projects are considered borderline viable and thus not entirely bankable. However, the emphasis is on borderline viability. It is not the function of the PT SMI to save an unviable project.

35. The MoF also relies on the PT SMI for project development funding, rather than on the Project Development Fund (PDF), which means that the PDF has become largely inoperative. The PDF resides within Bappenas and is largely funded by the Asian Development Bank (ADB). Bappenas houses the PPP Central Unit (P3CU). P3CU's role is largely to coordinate the identification of potential PPPs and putting them on the official PPP Book while the MoF assists in the preparation, finance and the provision of guarantees needed to create the PPP.

36. In response to the significant problems with regards to land acquisition, particular prominent in road projects (see discussion below), there is a Land Acquisition Revolving Fund (LARF) that must assist the Roads Authority to acquire land that the private partner needs for the PPP. Since ultimately the private partner is responsible for the acquisition of land, the payments of the private partners must replenish LARF and ensure that the fund revolves. It needs to be emphasised that this is the intention with LARF, as no such funding has occurred at the time of writing. In light of the new land acquisition law passed by Parliament on 16 December 2012 this fund's mandate and function may have to be revisited.

37. In addition to the above institutions there is also the KKPPI, which is an inter-ministerial committee chaired by the Minister for Economic Planning and co-chaired by the Economic Coordination Minister. Other members include the MoF and Bappenas and the Ministry of Finance. This committee is in principle responsible for coordination and the identification early on of priority projects. However, in deciding the priority of projects where such priority increasingly means the viability of the project, the RMU and IIGF increasingly fulfil the function of project approval. KKPPI has in recent years not been particularly active with regards to the PPP pipeline.

38. In the past GCA and other ministries could refer PPPs to the KKPPI when these PPPs encountered problematic regulations that were not suitable for the PPP. The KKPPI would then work towards solving these regulatory issues for the specific PPP. It thus dealt with problems in an ex post, and ad hoc manner. It may be preferable to set up ex ante a set of principles and institutions to guide the PPP process.

39. According to Presidential Regulations 67 of 2005, 13 of 2010 and 56 of 2011 the MoF plays a crucial role in the approval of PPPs. However, it might be argued that it comes into play quite late in the contract award cycle as the MoF seems to play little or no role in the identification of possible PPP projects.

40. Building on the above review of the contract award cycle and institutional roles regarding PPPs the following sections discusses the main challenges and possible solutions with respect to PPP governance. The sections are broadly based on the three categories contained in the OECD Recommendations for Public Governance of PPPs (see Appendix 1). More specifically, Section 5 relates to Category A (Recommendations 1 to 4), Section 6 relates to Category B (Recommendations 5 to 9), while Section 7 relates to Category C (Recommendations 10 to 12). Note that some of the subsections may also cross reference across categories. The different subsections below relate to the different recommendations in the following way:

***Section 5 (Category A: Recommendations 1 to 4)***

Recommendation 1, 2: Section 5.2, 5.3, 6.2

Recommendation 3: Section 5.6

Recommendation 4: Section 5.5

***Section 6 (Category B: Recommendations 5 to 9)***

Recommendation 5: Section 6.2

Recommendation 6: Section 6.1, 6.3

Recommendation 7, 8: Section 6.3, 6.4

Recommendation 9: Section 7.4 (but Section 7.4 deals mainly with Recommendation 12)

***Section 7 (Category C Recommendations 10 to 12)***

Recommendation 10: Section 6.4 (but Section 6.4 deals mainly with Recommendations 7 and 8), 7.2

Recommendation 11: Section 7.1, 7.3

Recommendation 12: Section 7.3, 7.4

## **5. ESTABLISH A CLEAR, PREDICTABLE AND EFFECTIVE INSTITUTIONAL FRAMEWORK SUPPORTED BY COMPETENT AND WELL-RESOURCES AUTHORITIES**

### **5.1 Summary of the OECD Recommendations regarding the institutional framework and capacities**

41. Governments should establish a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities. This means that the political leadership should ensure public awareness of the relative costs, benefits and risks of PPPs and conventional procurement. In order to maintain key institutional roles and responsibilities the procuring authorities, the Supreme Audit Institution and sector regulators should be entrusted with clear mandates with regards to PPPs.

42. The authority that is procuring the PPP is the institution ultimately responsible for the project, subject to approval, monitoring and advice from the other actors at various stages. At the same time The Supreme Audit Institution (SAI) has an important role ex post examining whether the risks involved in PPPs are managed effectively.

43. Sound regulatory policy promotes the efficient functioning of regulatory agencies by ensuring that they operate under an appropriate and clear mandate, with the necessary independence from political influence and regulated subjects. Given the complexity of PPPs and their infrequent use, critical skills to ensure value for money may need to be concentrated in a PPP Unit that is then made available to the relevant procuring authorities.

44. In order to prevent conflicts of interest promotion and scrutiny roles should not be the responsibility of a single unit. All significant regulation affecting the operation of PPPs should be clear, transparent and enforced. Red tape should be minimised and new and existing regulation should be carefully evaluated. Private investment will be facilitated if unnecessary red tape is removed and delays to approval processes are reduced.

### **5.2 Challenges in Indonesia regarding institutional framework and capacities**

45. With regards to the populations perception of PPPs there does not at this time appear to be much controversy. This may, however, be a result of the fact that few new PPPs have been put into operation in later years. In particular there have not been recent examples of PPPs where the full or partial cost recovery has fallen directly on users. When and if the burden of new PPP investments falls on the users experiences in Indonesia indicated that protest should not come as a surprise.

46. There is a great reluctance in GCAs with regards to the use of PPPs. For top decision makers in government it appears that GCAs do not wish to be responsible for PPP projects and have to be pressured by the political level into doing this. There also appears to be a lack of interest and capacity to follow up on projects which have been designated as potential PPPs. The process thus becomes weak in terms of quality and slow in terms of time.

47. The United Nations (2007) proposes a three-stage development model for PPPs. During the first stage the government defines the policy framework, tests legal viability, identifies a project pipeline and develops underlying concepts to guide project evaluation and the procurement process. The government also needs to start developing the PPP market. In the second stage the government establishes the PPP unit, develops the market and the PPP pipeline further. The third stage is more of an outcome than a process. The system is fully developed and legal impediments to PPPs have been removed. The system operates with the required skill, while risk allocation is sophisticated and funding is available for projects. Indonesia has progressed significantly with respect to the first two stages. However, there are still some challenges present that need to be addressed before it can move to the third stage.

48. The following two subsections focus on the following challenges:

- The lack of coordination between and capacity within the GCAs, Bappenas and the MoF
- Regulatory framework challenges

### **5.3 Coordination between and capacity within the GCAs, Bappenas and the MoF**

49. PPP activity in Indonesia mainly takes place in three centres in government: the GCAs (e.g. the ministries and sub-national authorities), Bappenas and the MoF. Unfortunately there seems to be a lack of coordination between these three centres. This lack of coordination manifests itself in the following:

- 1) The GCAs develop project proposals in isolation. This means that very often project proposals and feasibility studies fall short of the requirements of the MoF and subsequently may not qualify for government (fiscal) support and a government guarantee. The projects are then either abandoned or delayed as more work is done on the proposals.<sup>7</sup> While the MoF through its various organisations such as the Risk Management Unit (RMU) and the Indonesian Investment Guarantee Fund (IIGF) evaluates the financial and technical feasibility of projects, it does not assist the GCAs in putting together the feasibility studies.
- 2) The P3CU in Bappenas is tasked with assisting GCAs with developing their PPP project proposals. However, the P3CU has limited resources to do this which makes its job difficult. Evidence also indicates that the procurement rules P3CU is subject to effectively bars it from hiring good advisors which impacts on project preparation. In this effort the P3CU is supposed to be assisted financially by the Project Development Fund (PDF). However, the PDF falls short of its initial intended role, with some of its functions relating to the funding of the development stage of projects by the GCAs being fulfilled by PT SMI. There also seems to be a lack of coordination between P3CU and the MoF, leaving the P3CU and Bappenas to update the PPP Book, while the MoF operates independent of what P3CU does.
- 3) Questions have arisen concerning whether or not the P3CU has sufficient capacity to support GCAs in the identification and preparation of project proposals and feasibility studies.

50. With regard to PPPs the vastly different institutional cultures of Bappenas and the MoF somewhat weaken the coordination between the two institutions. Bappenas focuses on broad economic planning while the MoF has a stricter fiscal and financial focus. In most countries the evaluation of individual PPP project proposals rarely involves a consideration of the broader social costs and benefits. This is reflected typically in bids and public sector comparators (PSC) that focus exclusively on the *direct* (and not the broader social) outputs and costs of the project. This exclusive focus has its genesis in the

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7. An example of such a delayed project proposal is the Jakarta Airport link project.

nature of the project and financial management tools typically applied to PPPs. These tools very much reflect the strict criteria that the private sector applies to project finance, typically because their profitability depends on it. Because these stricter criteria do not include an explicit consideration of broader social benefits and costs, their application very often does not allow for an easy fit with the broader social and planning objectives typically found in ministries of planning. Indonesia seems to be no exception to this rule.

51. The lack of coordination between the P3CU and the MoF also means that there is a need to align the content and the level of detail and sophistication required by the MoF's assessment process and the nature of the support provided by the P3CU. Currently there seems to be a mismatch between the required level of detail and sophistication and the level of detail and sophistication of actual proposals that were put together with the support of the P3CU. Therefore, as in many other countries before, a need exists in Indonesia for better alignment. This alignment requires the proper location of the PPP unit to enhance cooperation with the MoF. As the experience of some of the countries that implemented successful PPP programs show, there mainly are two options with regards to locating the PPP unit to enhance the cooperation with the MoF. These options are:

1. Placement of the PPP unit inside the MoF. This is the model used by among other South Africa, and the Australian states of New South Wales and Victoria.
2. Placement of the PPP unit as an independent agency that is closely aligned with the MoF. This is the model used in the UK.

52. PPP units are usually located within the MoF if they have their genesis in the MoF. However, if they have their genesis elsewhere, they often become an independent agency. Since P3CU in Indonesia has grown out of Bappenas one option is to developed it into an independent agency. Both options, i.e. locating it in the MoF or placing it as an independent agency, should ensure that the institutional culture of the PPP unit and that of the MoF are aligned and enables both the PPP unit and the MoF to have a stricter fiscal and financial focus. A stricter fiscal and financial focus will allow the PPP unit to assist GCAs with tailoring their proposals and feasibility studies to the MoF requirements. Given that PT SMI currently fulfils many of the functions originally intended for the PDF. The PDF could either move with the P3CU, or it could be incorporated with the PT SMI,

#### **Box 4. Involvement of dedicated unit in the procurement cycle**

Appendix 3 presents an overview of the different actors involved in the procurement cycle. The overall picture emerging from the case studies is that the procuring government organisation is directly responsible for each phase of the procurement process, sharing indirect or direct responsibility with the PPP unit in selected stages.

The important exception to this is the project approval stage, which in Germany and Korea is the responsibility of the Ministry of Finance, not the PPP unit, and in the United Kingdom, Victoria (Australia) and South Africa is the responsibility of the PPP Unit, which is also part of the Department of Finance/Treasury. In South Africa, the National Treasury gives "Treasury Approvals" at various stages of the public-private partnerships procurement cycle: after the feasibility study, procurement, value-for-money report and when the project agreement management plan is finalised. In other words, when deciding on whether or not the project is deemed to be value for money and affordable, the final decision rests with the Ministry of Finance. After project approval, the tendering stage and post-award stage is handled by the procuring government organisation, assisted by the PPP unit (and in some cases the Ministry of Finance). (Adapted from OECD (2010))

53. Since particularly large-scale projects would ideally also be open and attractive to international bidders, project proposals and feasibility studies should adhere to international standards. International investors and project managers may include both financial institutions interested in maintaining a transnational portfolio of projects, or construction firms that also maintain a diverse portfolio of projects. In its attempt to attract international investors Indonesia will be competing with a number of other developed and emerging market countries. The Indonesian authorities are clearly aware of this issue and are working towards resolving it. One approach would be to consider appointing international transaction advisors for large PPP projects to ensure that these projects adhere to the standards international investors usually require from PPP project proposals. Such advisory services will probably require central funding as the GCAs will not be able to afford it.

#### **5.4 Regulatory challenges and land issues**

54. The regulatory framework for PPPs needs to support the overarching principles of good regulation, i.e. that it is clear, effective, proportional, flexible, transparent, consistent, predictable and accountable. Presidential decrees 67 of 2005 improved the regulatory framework substantially. However, there remain some challenges. Historically there have been problems with the legal framework being applied in a transparent, consistent and predictable way. In the past this has led to cases subjected to international arbitration. Questions regarding the enforcement of the international arbitration decisions that went against the public side have been raised in the past. There are no recent experiences with regards to these issues.

55. The Master Plan sets out ambitious plans to create six corridors in Indonesia to improve connectivity in the country. Until the passing of new legislation in December 2011 this was hampered by the legislative framework which makes it extremely difficult for the authorities to expropriate privately owned land. Road projects, be these PPPs, or projects undertaken by the Ministry of Transport and the Toll Road Agency, thus suffered from significant problems relating to the acquisition of the relevant land. This had two effects. First, owners delayed selling their land to the government/consortium for as long as possible in the hope that their bargaining position – and hence the price – would be strengthened as the project progressed. Secondly, because of the drawn-out negotiation process to acquire land, the extended time between identifying land for consideration and the GCA acquiring it allowed speculators to drive up the price of the relevant land. This led to a significant escalation in the actual cost of the land and total project cost.

56. In response there was put a requirement in place that land ownership by the GCA should be established by the time the contract is concluded, so as to reduce cost uncertainty. The government also imposed a cap on the price of the land it is willing to pay (at a 110% of the initial valuation). A Land Acquisition Revolving Fund (LARF) was also set up to ease the acquisition of land.

57. The expropriation framework has changed with the new legislation passed on December 2011. The new law regarding expropriation of land for public works and PPPs is considered a clear improvement. From the perspective of the investor it makes the timing of when the land will be available through expropriation more certain. The law sets rather tight deadlines for appeals of expropriation decisions and the level of compensation. While this is beneficial to speed up the process it may be a challenge for non-professional groups to handle. The law sets out the principle that compensation should be based on the market price of the land. It is, however, difficult to see how a clear valuation of the land is possible. Tax records are not directly useable as they appear to consistently understate the real value of land. The same can be said for the records of land sale prices. It should also be noted that the new law has not yet been promulgated in the form of a presidential regulation. In reality whether or not the new legislation solves the problems discussed above will to a great extent depend on the implementation regulation.

58. In addition, there are never still some unresolved issues with regards to land. There are cases where there are competing claims of ownership, but no documentation, e.g. in cases where there are claims that land is held in common by specific groups. The issue of overlapping jurisdictions can also impede PPPs. Where the resource/asset belongs to a lower-level authority, but the service crosses a jurisdictional border of those authorities, the higher-level authority becomes responsible for the PPP. The Umbalan Water Supply project is an example of such a project. The provincial government is responsible for the development of this project, but the project is being held up due to differences among the five local authorities that own the relevant water rights.



## 6. GROUND THE SELECTION OF PPP IN VALUE FOR MONEY

### 6.1 Summary of OECD Recommendations regarding value for money and introduction

59. All investment needs should be prioritised at the political level. The decision to invest should be based on a whole-of-government perspective and be separate from how to procure and finance the project. There should be no institutional, procedural or accounting bias either in favour of or against PPPs. Government should carefully investigate which investment method is likely to yield most value for money. Key risk factors and characteristics of specific projects should be evaluated by conducting a procurement option pre-test thereby enabling the government to decide on whether it is prudent to investigate a PPP option further.

60. Project risk should be defined, identified and measured and carried by the party for whom it costs the least to prevent the risk from realising or for whom realised risk cost the least. Value for money should be maintained during operation and possible renegotiation. Government should ensure there is sufficient competition in the market by a competitive tender process and by possibly structuring the PPP program so that there is an on-going functional market. Where competition is absent, once the contract has been awarded, the market should at least be contestable.

61. International experience with PPPs has shown that improved value for money is the only legitimate reason for undertaking PPPs. *Overall* government policy usually articulates what the government considers to represent value for money, which means that deviations from overall government policy reduce the overall value for money that the government seeks to deliver. With overall value for money is meant the right combination, from a policy point of view, of education, health service, infrastructure services etc. Policy priorities therefore drive what is considered the right combination of these government activities. The government also needs to ensure that each project *on its own* represents value for money, but now focusing more on economy, efficiency and effectiveness as well as delivering the right quantity and quality of the service.

62. This section first discusses the lack of an overall government structure that ensures that PPP activity in Indonesia aligns and coheres with the government's overall policy framework. This is followed by two subsections, the first considering the rationale for undertaking PPPs in theory, before the second discusses the rationale for undertaking PPPs in Indonesia

### 6.2 A new Presidential Committee prioritizing and championing projects

63. As mentioned above the fiscal and financial criteria applied to specific PPPs are usually direct and strict. There is, however, also a need to consider the broader societal costs and benefits of projects as well as the political priority of individual projects. Thus, there is a need to ensure that policy choices cohere and are aligned with the governments overall strategy, priorities and objectives. In the UK GCAs engaging in major projects, be these PPP or traditional infrastructure projects, need to indicate how each of these projects fits within the overall policy strategy and objectives of government. In Indonesia the various ministries involved in the creation of PPPs and non-PPP projects (including the line ministries, the MoF and Bappenas) seem to rarely discuss, for instance, the alignment of their plans to the overall policy strategy and objectives of government as set out in the Master Plan.

64. The active management of ensuring coherence of the entire portfolio of PPP and non-PPP projects and their compliance with the overall policy strategy and objectives of government needs to occur on the highest level of government. Two possible options to manage it on the highest level of government include:

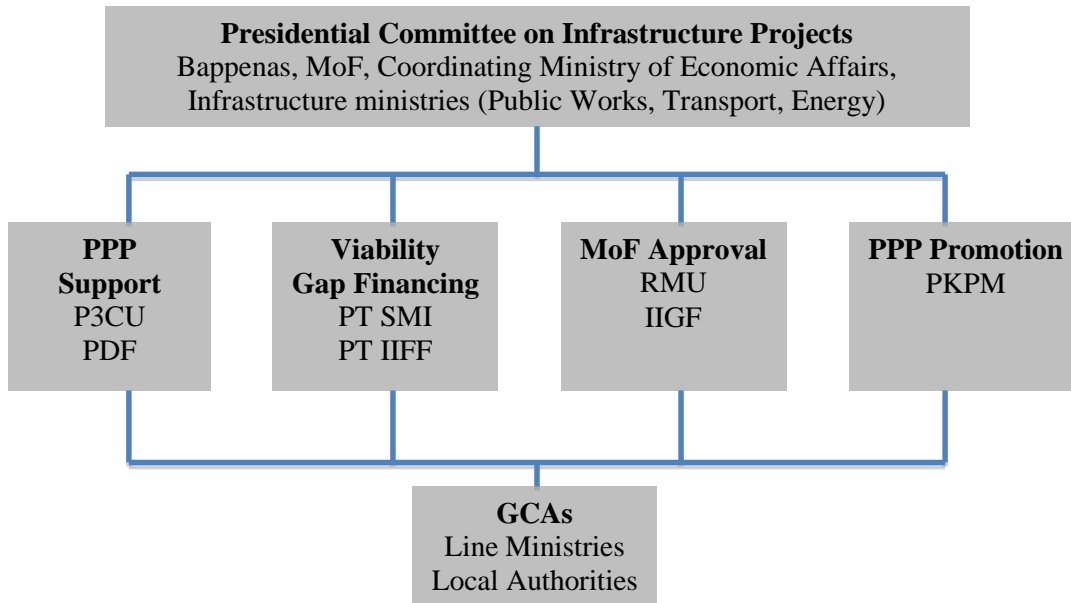
1. Cabinet approval is required for all major projects against the background of the government's policy strategy and objectives;
2. The responsibility to ensure coherence is allocated to the president's office, with the president (or vice president) chairing a high-level inter-ministerial committee responsible for the prioritisation and governance of projects to ensure that the portfolio of projects comply with the overall policy strategy and objectives of government.

65. Given the existing government structures in Indonesia, the second option above seems to be the most appropriate. A presidential committee for infrastructure projects chaired by the president, in which Bappenas, the MoF, the Coordinating Ministry for Economic Affairs as well as some of the line ministries responsible for infrastructure development are represented, could be an efficient structure. In this committee especially Bappenas, the MoF and the Coordinating Ministry of Economic Affairs could be expected to play key roles. Compared to the more focused role of the line ministries, Bappenas' role follows from its more holistic tradition of economic planning, while the MoF's role follows from the need to maintain sound budgetary practices and ensure that the planning conforms to the budgetary envelope. The Coordinating Ministry of Economic Affairs' role stems naturally from its function as coordinator of policy. The presidential committee would seem the ideal place to combine these three different views. Collectively this body would also work as a champion for PPPs creating a demand for line ministries and agencies developing such projects.

66. Bappenas' role in this committee can be further expanded to resemble that of the Australian Infrastructure Commission (AIC). The AIC ranks all infrastructure projects, be these PPP or non-PPP projects, according to cost-benefit analysis, the results of which are published and subsequently prioritised by government and parliament. The UK too has a committee that considers all major infrastructure projects, be these PPP or non-PPP projects. Therefore, Bappenas could undertake the broader social cost-benefit analysis, the results of which are then published and prioritised by the presidential committee on infrastructure projects.

67. The above proposal is summarised in Figure 1 that sets out a proposed institutional setup for PPPs in Indonesia. In Figure 1 the Presidential Committee on Infrastructure Projects ensures that all key players align their strategies and objectives to that of government. As mentioned above, Bappenas, the MoF and the Coordinating Ministry of Economic Affairs play key roles in this committee. The four boxes below this committee indicate the types of role players that GCAs need to engage in the PPP contract award cycle. These are PPP support (the P3CU and PDF), viability gap financing for projects that are borderline viable (PT SMI and PT IIFF), MoF approval (RMU and the IIGF) and PPP promotion (PKPM).

Figure 1. An institutional setup for PPPs in Indonesia



Note: See section on abbreviations and acronym for acronym explanation.

68. Once the presidential committee on infrastructure projects has approved a project, the GCA needs to initially assess whether delivering the project through a PPP or through traditional procurement represents the best value for money. If the PPP mode of delivery is selected the project enters the PPP project pipeline. In this pipeline the P3CU assists GCAs in preparing PPP documentation to ensure that the project proposal and documentation comply with the criteria set by, among other, the MoF and international and domestic investors. The PDF might provide financial support to GCAs to prepare the project proposal and documentation. Projects that are borderline viable might then also need to obtain viability gap financing to ensure that the project is fully viable before the MoF can provide final approval. PT SMI and PT IIFF are the key institutions playing a role in viability gap financing. MoF approval entails for the project to pass through the gateway process of approval discussed below. Note that obtaining viability gap funding and MoF approval are two processes that will probably run concurrently, though for final MoF approval the viability gap financing must be in place. Finally, PKPM undertakes the promotion of PPPs. Throughout all faces the GCA would be the key promoter of the PPP, but would be supported and scrutinised by the above-mentioned institutions at the various key stages. Furthermore, throughout the contract cycle the different actors should report to the presidential committee on progress made.

### 6.3 Pursuing PPPs for reasons of value for money and/or augmenting the public purse

69. As mentioned in section 2 of this chapter historically there have been several reasons why OECD and other countries implemented PPPs. These included *inter alia*:

1. A pursuit of value for money, and the associated selection of PPPs because of public sector and bureaucratic inefficiency and perceived private sector efficiency;
2. Augmenting public sector financial resources and getting projects off the books of government to ensure that individual government entities and government as a whole do not exceed a pre-specified budget envelope and concomitant balance sheet liabilities.

70. However, through experience and a better theoretical understanding developed over time, value for money came to be accepted as the principal and foremost reason to consider using PPPs instead of traditional infrastructure procurement. In addition, the literature also shows that PPPs do not necessarily deliver the desired value for money. Indeed, the literature identifies a list of preconditions that need to exist for PPPs to outperform traditional infrastructure procurement and represent value for money. These include requirements regarding competition, risk transfer and the measurability of risk and demand. These requirements are identified in Burger and Hawkesworth (2011:129-133) and reflected in the OECD Recommendation Number 6. A main lesson is that deriving value for money from a PPP is not a given and depends on institutional, market and project-level conditions.

71. The second reason for undertaking PPPs, augmenting public sector financial resources, is much more contentious and often based on a fallacy. In the case of a pure PPP, i.e. where the private partner will receive payment directly from government and not from end-users, the choice between traditional infrastructure procurement and a PPP means a choice between the following two options:

- 1) In the case of traditional infrastructure procurement government incurs the initial debt to finance the asset and thereafter pays the operational expenditure and interest on the debt. Thus, if the project implies additional expenditure for government, it will also require, over time, the need to raise additional revenue to service the debt and pay operational expenditure;
- 2) In the case of a PPP the government incurs no additional debt to finance the asset, as the private partner is financing the asset through raising capital in the form of loans and equity. However, since the private partner needs to service this debt and pay operational expenditure in future, it will need to raise enough income in future from government in the form of its annual payment of fees or user charges. Therefore, if the project implies additional expenditure for government, it will also require, over time, the need to raise additional revenue to pay the private partner a fee that will allow the private partner to service its debt and pay operational expenditure. Of course the payment of these fees is contingent on the private partner delivering in accordance with its contract. However, unlike contingent liabilities that are not expected to realise, the payments due under a PPP contract, though not certain, are nevertheless expected to realise. Therefore, PPPs create a less than certain, but nevertheless expected liability on the books of government in the form of the present value of all the service fees and user charges that government is expected to make to the private operator of the PPP. (Note that the value-for-money criteria implies that the present value of this expected liability should be *less* than the debt plus the present value of the operational expenditure that government would have incurred had it chosen traditional infrastructure procurement.).

72. Comparing points (1) and (2) shows that in both the case of traditional infrastructure procurement and a PPP government faces a liability. In both cases it will need to allocate revenue in future to service debt (either public debt in the case of traditional infrastructure projects or private debt in the case of a PPP) and pay operational expenditure. The only difference is that in the case of traditional infrastructure procurement government directly services the debt and pays the operational expenditure, while in the case of a PPP government pays these indirectly by paying the private partner a fee or user charge, with the private partner then servicing the debt and paying the operational expenditure.

73. In the case of a concession (without a subsidy of government) the concessionaire carries demand risk. Thus, it incurs the initial debt to build the asset and thereafter needs to raise a user fee on final users that is high enough to ensure that it can service its debt, pay operating costs (and of course yield a dividend to its shareholders). Thus, in this case, unless government subsidises the concession or provides guarantees, there seems to be no potential liability on the books of government. In reality some implicit

liability may very well be carried by government. This option is very often contrasted with the project being delivered through traditional infrastructure procurement where government is seen as the one paying for the servicing of the debt and the operational cost of the project by raising tax revenue. If the limit on the amount of revenue that government in future can be expected to raise then renders the project unaffordable (i.e. the project cannot be fitted within the budget envelope of the government contracting agency or government in total), a PPP in the form of a concession is then seen as the alternative to fill the funding gap.

74. However, this comparison is fallacious, as it confuses the mode of financing with the mode of raising the revenue needed to service debt and pay operating expenditure. The proper comparison is not between paying for the project through raising government tax revenue and paying for it using user fees levied by a concessionaire on final users. Making this comparison is also wrong as it presumes that government cannot levy user fees.

75. The correct comparison is between a traditionally procured infrastructure project where the debt servicing and operational costs are paid for by user fees levied on final users, and a PPP concession where the debt servicing and operational costs are also paid for by user fees levied on final users.

#### **6.4 The rationale for PPPs in Indonesia – the role of value for money and the funding gap**

##### *The limited role of value-for-money assessments in Indonesia*

76. Value-for-money assessment appears to play a somewhat limited role in the decision as to whether or not a project should be undertaken. It also plays a limited role when government identifies which projects are suitable for potential PPP status. This does not in itself mean that the elements of what would normally constitute part of a value-for-money assessment do not appear in the project identification process, just that the focus on value for money is not explicit. The focus of the PPP identification process is largely on economic, financial and technical viability and the possibility to transfer risk. For water projects there is also an analysis of the institutional capacity of the local authority to manage the PPP contract cycle (including their ability to evaluate tenders). It should be noted that this might reflect the fact that the new phase of PPPs in Indonesia is just beginning and tools have to developed in response to specific challenges (see also section 5.2).

77. In road projects the Road Authority makes an assessment of the user benefit of the toll road in terms of the time that road users will save when using the road versus the possible tariff that can be levied on the road users (the so-called vehicle operating cost (V.O.C.)) to establish whether or not the project will yield a net benefit. Whether the project is then identified as a PPP then depends on whether the project will deliver a return that is sufficient to draw a private partner. A need for high levels of maintenance and quality output also serve as motivation for selecting a project as a possible PPP candidate. In addition, the minimum levels of maintenance and output are defined as the minimum service levels of the project and in existing concessions are monitored on a six-month basis. Tariffs are usually renegotiated every two years and adjusted with inflation. However, should the concessionaire fall short of the minimum service levels the tariff adjustment can be postponed until such time that the concessionaire complies with the minimum service levels.

78. Following from the above, it is recommended that the Indonesian government develops a sectoral value-for-money assessment tool. This tool should focus on both the absolute and relative elements of value for money. With absolute value for money the question is whether the project represents value for money, while establishing relative value for money concerns the levels of value for money that different procurement options can deliver. Thus, relative value for money entails a comparison of the value for

money that traditional infrastructure procurement, procurement through a PPP or – as may be particularly relevant for Indonesia - procurement through an SOE can deliver.

79. Value-for-money assessment encompasses the financial and technical viability analyses that the Indonesian government currently undertakes. However, value for money also entails other elements that may be summarised as (see Appendix 4 for more detail):

- 1) Economy in the use of resources: minimise the cost of inputs;
- 2) Efficiency: maximise outputs per input;
3. Effectiveness: maximise outcomes (e.g. increase in the level of trade due to road connection) per output (number of cars using toll road).

80. In general value for money can be defined as the optimal combination of quality, quantity, features and price of the project, calculated over the whole of the projects life. Thus, a value-for-money assessment requires an intertemporal assessment across the whole of the project's life and not only for the current budget year. Only when a whole-of-life approach is followed, can government really assess whether the project delivers optimal value for money, i.e. whether the quality and quantity and features of the project justifies the price paid over its whole life.

81. The value-for-money assessment should also take fully account of risk, so that all comparisons across procurement options are done on a fully risk-adjusted basis. In addition, care should be taken to price risk correctly and not under- or overestimate it.

### ***The funding gap as the main motivation for undertaking PPPs in Indonesia***

82. Prior to the Asian crisis public investment in Indonesia was at just below 10% of government expenditure. Many of these projects were undertaken by Indonesian SOEs and through other arrangements with the private sector where private operators were directly appointed to build and operate assets. However, in the aftermath of the Asian crisis in 1997 many of these projects turned out to be not financially viable. In addition, in the almost a decade and a half since the crisis government investment decreased sharply to about 4% of government expenditure. As a result there has been a large underinvestment in public infrastructure during this period. This includes almost all types of public infrastructure, ranging from power generation, roads, rail, ports, airports and water purification and distribution. The lack of investment has been ascribed mainly to the so-called funding gap, i.e. the government's budget envelope is insufficient to undertake enough investment. Thus, there is limited scope for government to raise more taxes in future. In addition, many of the local government SOEs in water still have large outstanding debts stemming from the period prior to the Asian crisis and they are not allowed to borrow again unless they have repaid these debts.

83. To address the by now large backlog in infrastructure investment, the Indonesian government launched the Master Plan. The Master Plan sets out the intention of the government to increase investment in all the types of infrastructure that in particular relates to connectivity in Indonesia. Thus, a large emphasis is placed on the development of six corridors, as well as inter-island linkages.

84. Largely because of the abovementioned budgetary limitations the government plans to rely mostly on the private sector to undertake the infrastructure investment set out in the Master Plan. Part of the private sector's contribution is in the form of PPPs, with the Master Plan indicating that PPPs should contribute 21% to the infrastructure investment (compared to traditional infrastructure investment by central and provincial governments being at about 10%). Many, if not most, of these PPPs will be in the form of concessions. One example is the various toll road projects envisaged. Other examples include

independent power generators supplying power to PLN (the SOE responsible for the generation of electricity and envisaged to act as the public partner in many projects), with PLN then selling the electricity to local authorities, which, in turn, sell it to final users.

85. Unfortunately, it seems that due to significant limits on the budgetary envelope of government the preference for PPPs stems from a confusion of the mode of finance with the mode of raising the revenue needed to service debt and pay operating expenditure. Thus, because of the limits to which tax revenue in future can be raised (and thereby limits the amount of debt government is now willing and able to incur to pay for infrastructure) and because of the limited ability by among other the local authority water sector SOEs to borrow, the government plans to use PPPs mostly as concessions. It has been argued that these concessions will be able to raise debt that the government could not raise since the concessions will mostly be dependent on user fees levied on final users (though large state guarantees will also be required for the project to go ahead in most cases).

86. While there may very well be practical issues that inhibit tax increasing in particular circumstances, the above argument is problematic. In principle the government or an SOE can also levy user fees on final users, changing the mode of raising revenue for the project does not automatically imply the use of a PPP. Changing the mode of raising revenue (i.e. tax revenue versus user fees) will not render these projects more viable since the tax revenue base of government largely overlaps with the consumer base upon which either government or a private producer will levy direct user fees (if anything, the consumer base might be narrower). Thus, shifting payment from taxpayers to consumers will not render the project viable.

87. Furthermore, if the saving pool accessible to Indonesia is insufficient to finance public sector debt (i.e. bonds issued by general government and SOEs), then it will presumably also be too small to finance those very same projects via the private sector (either as pure private sector projects or as PPPs). Conversely, if the pool that the private sector can access is large enough to finance the projects, then, in principle, the public sector should also be able to do so. Given the Indonesian government's consistently improving credit rating and long term strong growth prospects it is also unclear why the market should be very hesitant to buy government bonds at a reasonable yield.

88. It would consequently appear to be of value to the Indonesian government to clarify the reason PPPs are expected to deliver such a large part of the infrastructure gap. This is not to say that this mode of delivery is flawed or that the potential is not there, but PPPs are only one of several alternative delivery mechanisms and do not in themselves change the basic dynamics of the Indonesian economy. In addition, to ensure value for money it may be more productive to decide which projects should be PPPs on a case-by-case basis rather than by virtue of a target for the stock of PPPs.

### ***The absence of a strong gate-way process to secure value for money***

89. As discussed above, once the presidential committee approved a project and the GCA identifies the project as a PPP project, the GCA needs to conduct a feasibility study. P3CU will provide technical assistance to GCA to compile the feasibility study. The feasibility study needs to contain an assessment of the economic, financial and technical feasibility of the project. In addition, the GCA also needs to consider social and environmental aspects. Once this is done, should the GCA wish to obtain government guarantees and fiscal support, it needs to submit the project proposal and feasibility study to the MoF, which should act as the gate-keeper for value-for-money considerations. In the case of guarantees, which most of these projects require, the IIGF assesses the different feasibility studies. Should, on the basis of the criteria set for economic, financial and technical feasibility, the IIGF be satisfied with the different feasibility studies, it will issue a guarantee to the winning bidder. Since investors will probably not be interested in the PPP without the guarantee, the IIGF's role is the closest that the Indonesian authorities

come to a gateway process to green-light PPP projects. A gateway process typically involves several stages, in each of which the GCA needs approval (green-lighting), from the MoF – as in South Africa and Victoria (Australia) – before it can proceed with the next stage.<sup>8</sup>

90. From the gateway processes followed in South Africa and Victoria (Australia) it is clear that approval is required from the MoF. However, what is also clear is that the approval activities of the MoF occur in lockstep with the support activities of the PPP unit. This seems to be an element that is somewhat missing in Indonesia, which impedes securing value for money. In terms of governance it is in principle better if the advisory and approval functions are separated into two institutions. The different phases of a PPP project typically involve the following stages:

- 1) Planning;
- 2) Feasibility study;
- 3) Tender preparation;
- 4) Bidding and contract signing;
- 5) Construction; and
- 6) Operation.

91. Typically gateways can be implemented at the end of phases (1) to (4). Thus, the PPP unit will advise the GCA in the planning of the project, after which the MoF will consider whether the plan adheres to certain key characteristics required from a PPP. This check would look both at whether or not the project overall is worth doing and whether or not it looks prudent to pursue a PPP-procurement option for this capital asset (ideally a procurement option pre-test – see Burger and Hawkesworth 2011). Once the GCA receives the green light from the MoF the PPP unit assists the GCA in conducting its feasibility study. This feasibility study includes a whole-of-life approach to assessing value for money. Again the feasibility study is submitted to the MoF. Once the MoF provides a green light, the GCA can proceed with the preparation of the tender documentation. Along with the tender documentation the GCA should also prepare a public sector comparator (PSC) or equivalent value-for-money assessment tool that creates a benchmark/reference model against which the PPP bids can be compared to assess value for money. Again, the PPP unit assists the GCA. The GCA submits the tender documentation together with the PSC or equivalent benchmark/reference model to the MoF. Only if the MoF approves the documentation can the project be put out on tender. Once the GCA receives the bids it needs to select a preferred bidder. In doing so it needs to weigh up every bid against the PSC or equivalent benchmark/reference model. It also needs to conduct a due diligence on the preferred bidder. Should only one bid be received, the projects should be retendered. The GCA should submit all bids as well as its rationale for selecting the preferred bidder to the MoF, which then considers the documentation for approval. Simultaneously the CGA should, with the assistance of the PPP unit, prepare and negotiate the PPP contract and also submit that to the MoF for approval. Once the MoF is satisfied with the selection of the preferred bidder as well as the PPP contract, can the contract be signed. Once the contract is signed construction starts, followed by the operation of the PPP. The GCA needs to monitor (and therefore have the capacity to monitor) the construction and operation of the PPP project until termination. Should either the private partner or the GCA renegotiate a substantial part of the agreement, that contract alteration should go through the same gateway processes that new contracts go through.

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8. Appendix 2 sets out the gateway processes in South Africa, Victoria (Australia) and Korea.



92. While the above gateway process that ensures value for money does not at this point seem to be institutionalised in Indonesia, there presently are elements of the process that can be built upon. The P3CU assists the GCA in the beginning of the process, the RMU, MoF and the IIGF scrutinise the project's viability. It is still early days for PPPs in Indonesia and it takes time to build up a robust process that ensures value for money. However, an explicit focus on a coherent gateway process and the development of an explicit value for money tool will be worth prioritising in the near term.

## **7. USE THE BUDGETARY PROCESS TRANSPARENTLY AND ENSURE THE INTEGRITY OF THE PROCUREMENT PROCESS**

### **7.1 Summary of OECD Recommendations regarding using the budgetary process**

93. The budgetary process should be used transparently to minimise fiscal risks and ensure the integrity of the procurement process. In line with the government's fiscal policy the Ministry of Finance (Central Budget Authority) should ensure that the project is affordable and the overall investment envelope is sustainable. The project should be treated transparently in the budget process. The budget documentation must disclose all costs and contingent liabilities. Special care should be taken to ensure budget transparency of PPPs covers the whole public sector. The necessary procurement skills and powers must be made available to the relevant authorities to guard against waste and corruption and ensuring the integrity of the procurement process.

### **7.2 PPP-procurement, the ordinary budget process and measures taken to ensure the integrity of the PPP procurement cycle**

94. It should be born in mind that to date only one project has been brought to financial close based on the new framework for PPPs. Processes, methods and procedures will consequently be developed in the coming months and years. Indeed, the Ministry of Finance is presently working on developing guidelines for determining viability gap financing (fiscal support) of PPP projects. At this point there has not been given direct fiscal support to PPP, apart from the guarantees and subsidized loans issued by IIGF.

95. Large traditional infrastructure projects need to be submitted to Bappenas, the Cabinet and the MoF for approval if above a certain threshold. As mentioned above only those PPPs that require a government guarantee and/or fiscal support are submitted to the MoF (estimated to be the great majority of potential projects).

96. The question of affordability (i.e. whether the project life cycle costs fit within the medium-long term budget envelope of the GCA or government in total) is not addressed explicitly. Given the infrastructure gap and the rapidly growing Indonesian economy long term affordability may not be a great concern, but it still requires attention and transparency. In addition, there are substantial liabilities associated with PPPs in certain sectors, such as energy and water, due to the large subsidies needed to maintain maximum prices for users. This is illustrated by the fact that up to 40% of discretionary budgetary spending goes towards funding energy subsidies in Indonesia. A lack of a method for assessing affordability might consequently pose a fiscal problem for Indonesia in the years ahead as the PPP program is enlarged.

97. The MoF RMU assesses the fiscal risks that PPP projects represent in terms of contingent liabilities. The RMU prepares the 'fiscal risk statement'. This has been a part of the budget documentation since 2009. It is about 20 pages in length and discusses risks to the budget such as external global risks, contingent liabilities related to guarantees and other infrastructure projects and risks stemming from SOEs.

98. With regards to capital budgeting for traditional infrastructure construction Indonesia has the problem that the budget is solely on a one year basis. Consequently the plan is to set up an off budget fund that can secure financing of capital projects. It is not entirely clear why an off budget fund is necessary. The most common method of appropriating for capital investment in OECD countries (16 countries) is to provide funding incrementally each year until the project is completed. No OECD countries set up off budget funds as a general way to finance capital investment (OECD Budget Practices and Procedures Database 2007).

99. As discussed further below an SOE can act as the public side in a PPP deal. In terms of the annual budget SOEs receive a subsidy according to their ‘public sector obligations’- i.e. where they perform public service tasks, typically in the form of politically set maximum utility charges born by consumers. This is appropriated via the annual budget and adjusted according to the budgeted and later realised loss the SOE incurs as a consequence of the public sector obligation activities.

100. International donors may undermine the MoF’s efforts to build and maintain a coherent pipeline process for infrastructure projects. This happens when donors cherry pick a project in cooperation with the line ministries and then present it to the MoF as a done deal. It is important that any donor funds are integrated into the budget process in order to make sure projects adhere to the overall government priorities.

101. Table 4 below sets out the tools used in the procurement cycle in the case of respectively PPPs and traditional procurement in Indonesia. As can be seen from the tools applied to PPPs, PPPs are subjected to stricter treatment than that applied to traditionally procured projects. In principle, to ensure an equitable treatment of all projects, it is desirable for all projects to be treated similarly and the current practise differs from that of most OECD countries (Burger and Hawkesworth 2011:105).

102. PPP procurement is not subject to particular integrity or anti-corruption initiatives. However, anecdotal evidence suggests that since PPPs are subject to extensive scrutiny by many parties they may be less subject to the risk of corrupt practices. In addition a more transparent treatment in the budget documentation of PPPs would probably also add to this benefit.

**Table 4. Tools used in the procurement cycle in the case of respectively PPPs and traditional procurement**

	PPP			TIP		
	Y	N	S	Y	N	S
Post-award risk assessment of financial vulnerability of contractors		X			X	
Limits on the size of projects			X			X
Project risk indicators (quantifying risk)*			X			
Guidelines for risk allocation in projects (between government and private providers/contractors)	X				X	
Provision in budget for estimated risk	X				X	
Other	X				X	

PPP: Public-private Partnership, TIP: Traditional Infrastructure Procurement

Legend: Y: Yes, N: No, S: Sometimes

\* None of the options were selected for TIP

This list is compiled using the “OECD 2009. Enhancing Integrity in public procurement: A toolbox”

### 7.3 The challenges of SOEs

103. Special care should be taken to ensure budgetary transparency of PPP covers the whole public sector (central, provincial and local authorities as well as SOEs).

104. Similarly the roles of the different players should be transparent and not represent a conflict of interest. Currently SOEs still play a substantial role in infrastructure delivery in Indonesia. However, this role is problematic for two reasons:

- In some sectors the regulator-operator roles have not yet been separated and in those cases where it has been separated the relationship between the regulator and the operator is still very close, thereby possibly upsetting potential private investors.
- Some SOEs act as ‘private’ bidders in PPP bids. This creates a conflict of interest for government, which as the owner of the SOEs, have to decide between bids received from both the SOEs and private bidders.

105. The main sectors affected by these problems are some of the main infrastructure sectors, mainly roads, ports and airports as well as water, discussed below. In the energy sector PLN usually acts as the public partner and not a private partner.<sup>9</sup>

106. There are 17 toll roads operated by the SOE and another 11 by private partners. Most of these projects had their genesis in the 1980s. Approximately 760km of road are operated as toll roads, of which more than 50% are operated by the SOE. In addition, there are also 24 projects where award to a concessionaire occurred, but where the project stalled because of land acquisition problems. With the reform that occurred following the introduction of Law no. 38 of 2004 the role of the toll road authority and the toll road SOE changed significantly. Prior to the introduction of the law contracts were awarded to the SOE. However, after the introduction of the law a competitive bid process is followed, with private bidders bidding together with the SOE for contracts. Agreements are then concluded between the Roads Authority and the successful bidder, which therefore might be either a private bidder or the SOE. Therefore, the SOE might assume the role of the private partner in the PPP agreement. The possible role of the SOEs as potential ‘private’ partners, competing with truly private bidders creates a clash of interest for the government, as the government has an ownership interest in the SOE and thus, in one of the parties competing for contracts. Such a clash of interest may undermine the integrity of the tender process and scare potential investors away.

107. Pelindas is an SOE that operates four ports in Indonesia. Legislation passed to separate the operator and regulator functions, leaving the Ministry of Transport as regulator and Pelindas as the operator. However, the government has not yet finished writing the implementing regulations needed to fully operationalise the new legislation. Pelindas is planned to operate as a fully corporatized entity. There are two airports operating as corporatized SOEs, but as with ports, there is legislation to separate the operator and regulatory functions, with implementing regulations still being written.

108. Water is mainly a function of the local authorities, of which there are roughly 400. Each local authority also operates its own water SOE. As mentioned above, there are five PPPs in the pipeline, two of which are classified as potential PPPs and the other three as ready for offer. As with roads, SOEs are allowed to enter bids together with private bidders. Therefore, again, there is a clash of interest for the government.

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9. In the power generating sector PLN is the main player. PLN is an SOE that in the past also concluded a series of still existing contracts with foreign investors to create independent power producers (IPPs). These included investors from Japan, Korea, China and the US. These contracts typically took the form of direct appointment of the IPP. Thus, no competitive bidding process took place. In addition, the government in the form of the Ministry of Energy pays a subsidy to the power sector to cover the shortfall between their selling price set by the government and the cost of production. PLN also acts as the public partner in the only PPP created to date (Central Java Power Plant) – though it is not yet operational and the plant still needs to be constructed. A competitive bid process was used to allocate the contract, with a Japanese and Indonesian consortium winning the bid. This contract is the first (and only to date) contract to have been awarded after proceeding through the process set out in Presidential Regulation 67 of 2005. Unlike the roads sector, the energy sector suffers less from the land acquisition and property rights problems that exist in some of the other sectors. As a result concessions seem to work better in the power sector, as is also evident from the award of the Central Java Power Plant concession.

109. Though SOEs are corporatised and therefore, in principle, operate at an arm's length from the government, concern may still exist about the closeness of the relationship between the regulating/contracting authorities and the various SOEs. This concern is further strengthened given that in some sectors such as ports government has not yet finalised the implementing regulations to give effect to the separation of the operator and regulator functions in those sectors.

110. There is also a possible conflict of interest, with the government having to decide between awarding a contract to a private firm, or a firm in which it, as the government, is the main (or in many cases the only) shareholder. To rectify this situation the government will have to distinguish clearly between public-*private* partnerships procurement (which excludes SOEs from the bidding process) and public-*public* partnerships procurement (which are agreements between the government and SOEs, but excludes private bidding). The government could then still draw up a comparator to establish whether a public-*private* partnership with a private firm or a public-*public* partnership with an SOE will deliver the most value for money. Nevertheless, making a clear distinction between the two forms of procurement and not allowing SOEs to bid against private firms will prevent a conflict of interest that would undermine the legitimacy of the bidding process. This is not an issue that has come to the fore as of yet. Indeed the only PPP gone through under the new regulation has been where the SOE represented the public side. However, as the PPP program expands these issues should be addressed. If these issues are not addressed, they may undermine the integrity of the procurement process and scare investors away.

## 8. CONCLUSION AND PROPOSALS

111. Important elements of a good PPP framework for Indonesia are in place. This includes regulation and institutional roles. As with many countries there are some measures that should improve performance. This is to be expected as the new PPP framework is in its infancy. It should also be emphasised that a key element in developing a good framework for PPPs is by constantly refining the system based on lessons learnt in its application.

112. The government should consider the creation of a **presidential committee** for infrastructure projects, chaired by the President, in which Bappenas, the MoF, the Coordinating Ministry for Economic Affairs, as well as some of the line ministries responsible for infrastructure development are represented. The committee should ensure that all actors in the government align their infrastructure decisions with the overall strategy and objectives of the government. It should prioritise projects and act as the champion of PPP policy in order to overcome bureaucratic inertia. By anchoring the process at the highest political level legitimacy, momentum and whole of the government prioritisation will be ensured.

113. The government should take steps to **strengthen capacity within the GCAs** with regards to all the key phases of PPP procurement. A special emphasis on planning, feasibility studies and the preparation of tenders should be beneficial.

114. Such capacity enhancement requires a **stronger PPP Unit** that can support the GCAs throughout the procurement process. The most appropriate model for this PPP Unit might be as an independent agency that closely aligns with the MoF. This is the model used in the UK. In addition, the Project Development Fund (PDF) and the Sarana Multi Infrastruktur (PT SMI) should eliminate any duplication.

115. The **MoF should play a key role at all gateway stages** of the project and act as a gate-keeper. All infrastructure investment decisions, be these PPP or non-PPP projects, should be subject to scrutiny and approval by the MoF. This will place PPP and non-PPP projects on the same footing. The link between the PPP project process, RMU and MoF budget process should be strengthened. Special care should be taken to identifying and assessing contingent liabilities. Affordability analysis should be strengthened.

116. **Value for money should be the basis on which to select projects.** Filling the funding gap should not in itself be the main motivation for selecting PPPs as a mode of procurement. Value-for-money assessment should be done both for absolute and relative value for money. Absolute value for money concerns whether or not a project represents value for money for society. Relative value for money concerns the relative value for money delivered by the various modes of procurement (traditional vs. PPP). In assessing value for money, the government should take a whole-of-life approach that considers the present value of future costs and benefits. Only on this basis can a proper assessment of value for money be made. In addition, the government should use a public sector comparator or equivalent benchmark/reference model against which it compares bids received.

117. Effort should be put into developing a **shortlist of a handful of relatively straight-forward PPP projects.** A well known sector where the public side already has experience, such as roads, might be the relevant. There is human capacity to assess road projects in the Toll Road Authority and it is a fairly standard product. It should **be set in motion at the central government level and rolled out to local governments when a good standard model has been established based on experiences.**

118. A clear distinction should be made between public-*private* partnerships procurement (which excludes SOEs from the bidding process) and public-*public* partnerships procurement (which are agreements between the government and SOEs, but excludes private bidding). The government could then

still draw up a comparator to establish whether a public-*private* partnership with a private firm, or a public-*public* partnership with an SOE will deliver the most value for money compared to traditional infrastructure procurement. Making a clear distinction between the two forms of procurement will prevent a conflict of interest undermining the legitimacy of the bidding process.

119. The government should consider using **international transaction advisors** for high priority projects. This will ensure that project proposals and feasibility studies are done with the quality and sophistication required by international investors.

120. Donor's should not be able to cherry pick infrastructure projects and by-pass the ordinary gateway and budgetary process.

121. Preferably the Indonesian the government should follow the example of South Africa and **not engage in unsolicited bids**. However, should it decide to engage in unsolicited bids, it should, following the example of Korea, subject these bids to much higher standards to ensure the legitimacy and integrity of the procurement process.

## APPENDIX 1

### DRAFT OF THE OECD RECOMMENDATION FOR PUBLIC GOVERNANCE OF PPPS

122. With regards to PPPs the decision makers face the trade-offs between three demands inherent in a PPP project process. First, the public sector must be a prudent fiscal actor. It falls on the decision maker to ensure that the PPP is affordable, that it represents best value for money, and that any fiscal risks, such as contingent liabilities, are limited. Second, the demands for investment from particular sectors such as transportation, health and education have to be assessed prudently against each other so that the projects that are pursued are those that yield the highest return on investment for society as a whole. Finally, private investors wish to make the best deals possible, which often mean limiting the amount of risk they are carrying. However, inadequate risk transfer to the private investor undermines the rationale for undertaking PPPs in the first place. Decision makers must thus balance the risks taken by the private sector and those retained by the public sector in light of a realistic assessment of the price of these contracts. There is not necessarily one right solution to these trade-offs; much will depend on the specific of each project. However, general guidelines can be developed based on the experience of OECD countries in dealing with these issues successfully or less successfully.

123. The following Recommendations are meant to guide policy makers when using PPPs. They cover the governance pre-conditions for successful use of PPPs with regard to the institutional framework and the skills and competence of the relevant authorities; how to ground the selection and management of PPPs in a value for money; the use of the regular budget process to minimise fiscal risks and long term sustainability.

#### **A. Establish a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities**

*1. The political leadership should ensure public awareness of the relative costs, benefits and risks of PPPs and conventional procurement. Popular understanding of PPPs requires active consultation and engagement with stakeholders as well as involving end-users in defining the project and subsequently in monitoring service quality.*

124. Only if the political level is aware of and accepts the costs and benefits of using PPPs can the issues around PPPs be tackled and balanced appropriately with stability and predictability. The Ministry of Finance, line Ministries and executive agencies should ensure that a coherent approach to PPP is rolled out in the public sector and is joined up with other initiatives in adjacent fields. Given their complexity and long-term scope engagement with civil society is a prerequisite for the successful use of PPPs. This is especially the case when PPPs provide key public services. PPPs should, ideally, form part of an integrated public-sector infrastructure investment and procurement framework.

125. Active consultation and engagement with stakeholders should be an integral element of the process. PPPs may be used to introduce a more private-sector approach to service delivery in sectors that have previously been a part of the government. This can have effect on both working conditions, the culture of the work place and opportunities for advancement. Labour unions consequently represent a key stakeholder group that can be substantially affected by the usage of PPPs. For PPPs to work and to be legitimate, labour should be actively involved. The same can be said for NGOs and other civil society groups that often have concerns that PPPs may have social and environmental consequences and impact the rights of minority groups. Active involvement of NGOs can create transparency about problematic issues that might otherwise be overlooked and become serious problems if not tackled at an early stage.



126. Defining outputs in the PPP contract is essential. It should involve end-users in defining the project and its output specification and subsequently in monitoring service quality once the project is operational. Defining outputs can be instrumental in achieving better alignment of service specification with user expectations and exert pressure on service providers to meet service standards. In addition, involving end-users in design and monitoring increases the likelihood of the effort being perceived as legitimate, fair and understandable. Independent public oversight of PPP implementation can also promote public sector innovation and better outcomes for the society as a whole through greater accountability and social control.

**2. *Key institutional roles and responsibilities should be maintained. This requires that procuring authorities, the Supreme Audit Institution and sector regulators have to be entrusted with clear mandates with regards to PPPs to ensure clear lines of accountability.***

127. A number of institutional roles need to be competently pursued to secure and maintain value for money: a sound procurement process; implementing the specific PPP; auditing of the PPP; rule monitoring and enforcement. These roles can be maintained in a number of institutional set-ups, but it is important that they are kept separate so as not to confuse the key tasks of each actor and to secure lines of accountability. In addition PPPs raise budgetary and fiscal issues that are tackled below and particular capacity issues (the PPP Unit) discussed under 3.

128. The authority that is procuring the PPP is the institution ultimately responsible for the project, subject to approval, monitoring and advice from the other actors at various stages. The authority is responsible for preparation, negotiation and administration of the contract and for monitoring and evaluating contract performance during the construction and operation phases of the project. This is crucial to ensure the government retains value for money during the whole life of the contract. This authority is, therefore, ultimately responsible for the PPP contract and its operation.

129. The Supreme Audit Institution (SAI) has an important role in examining whether the risks involved in PPPs are managed effectively. The SAI's reports to Parliament can keep the public informed about the services that they receive and also disseminate best practice. The SAI should audit and assess the PPP ex post with regards to performance, finance and compliance. It should maintain sufficient capacity to give a clear verdict on whether or not the project ultimately represented value for money, suggest possible improvements to the regulatory PPP framework, the procurement processes and make available overall lessons regarding the use of PPPs and investments. All relevant information should be made available to the SAI.<sup>10</sup>

130. Sound regulatory policy promotes the efficient functioning of regulatory agencies by ensuring that they operate under an appropriate and clear mandate, with the necessary independence from political influence and regulated subjects, that they are appropriately resourced and equipped, and that their decision-making is fully transparent and accountable. Where PPPs are employed in the delivery of infrastructure facilities with natural monopoly characteristics, the role, design and organisation of regulators is important to secure value for money for the public sector and protect users and consumers. This role should be clear to all (staff, regulated entities and the community). The appropriate sector regulator should consequently be consulted in the project design and subsequently monitor compliance with regulated service standards. This role is important not only in shaping the markets, but also with concrete issues such as service quality, profitability, tariffs and prices. Of particular interest in monopoly-like situations is the degree of profitability compared to the sector average using various benchmarks.

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10. See INTOSAI Guidelines on Best Practice for the Audit of PPP and Concessions (2007); INTOSAI Guidelines on Best Practice for the Audit of Risk in Public/Private Partnership (2004).

131. The above roles need also to be institutionally maintained at sub-national level.

**3. *Ensure that the necessary resources and capacities are present in the public sector to assist the competent authorities. Given the complexity of PPPs and their infrequent use, critical skills to ensure value for money may need to be concentrated in a PPP Unit that is made available to the relevant authorities.***

132. Dedicated Public-Private Partnership Units exist to fulfil specific functions that correct government weakness, including augmenting PPP expertise and capacity that may be insufficient within responsible authorities. The PPP Unit can fill gaps in terms of specific skills, a lack of coordination or high transaction costs. Institutional shortcomings should be addressed taking the country's needs and current institutional context into account.

133. The PPP Unit should enable authorities (e.g. line ministries) to create, manage and evaluate a PPP efficiently and effectively. This role requires that the PPP Unit has the requisite in-depth financial, legal, economic and project management skills. This capacity should be used to assess the specific PPP compared to the traditional public investment route. The PPP Unit should support the authority in its endeavour to secure value for money both in the procurement and in the implementation phases. This Unit should also make sure that procedural steps (gateways) are followed throughout. It is important that the role of the PPP Unit is clear and without conflicts of interest. While responsible authorities should draw on expertise from the PPP unit where necessary, it should be emphasized that they remain ultimately responsible for the project. Importantly, although the Unit should help the relevant authorities prepare and negotiate the PPP contract, it should not decide on whether the PPP should move forward. This green-lighting process should be anchored in the Central Budget Authority.

134. In order to prevent conflicts of interest promotion and scrutiny roles should not be the responsibility of a single unit. Conflicts of interest may arise, for example, if the PPP Unit is both charged with promoting PPPs, in terms of courting domestic and foreign investors, as well as critically scrutinizing them in the approval process.

**4. *Ensure that all significant regulation affecting the operation of PPPs is clear, transparent and enforced. Red tape should be minimised and new and existing regulation should be carefully evaluated.***

135. A regulatory environment that meets the key principles of good regulation, as set out in the OECD Recommendation on Regulatory Policy and Governance, reduces the costs to business and enhances the chances that PPP projects bring value for money.

136. While the contract is the main basis for a PPP, it is necessary to have a clear and transparent regulatory framework that all parties can trust, is enforced and that does not create barriers to entry. Such a framework fosters competition and helps minimising the risk of conflicts of interest, regulatory capture, corruption, and unethical behaviour. To that end, governments should adhere to principles of open government. Access to information and the decision-making process needs to be open and equitable.

137. Private investment will be facilitated if unnecessary red tape is removed and delays to approval processes are reduced. An effective regulatory framework implies careful evaluation of new regulations and systematic review of the stock of significant regulations to ensure that they are up to date, cost effective and consistent and deliver the intended policy objectives. This may require the coordination of approval processes in specific circumstances to remove regulatory obstacles to the delivery of PPPs, such as coordinating and streamlining multiple layers of regulation that may affect projects – either across one or different levels of government (central/federal, sub-national/state and local).

## **B. Ground the selection of PPPs in Value for Money**

**5. *All investment projects should be prioritised at the political level. The decision to invest should be based on a whole-of-government perspective and be separate from how to procure and finance the project. There should be no institutional, procedural or accounting bias either in favour of or against PPPs.***

138. It is important that the projects that go ahead have been prioritized at the political level. The basis for the decision should include an initial cost assessment and evaluation of the opportunity cost that should feed into the affordability decision. The decision to invest should include a holistic cost-benefit analysis addressing the project's interaction with other government policy tools (such as spatial planning, regulation of traffic, utilities, and development plans) and objectives. Line ministries and other actors should not be allowed to develop their investment programs without aligning them with the government's overall political priorities.

139. On the basis of the initial cost assessment, the holistic cost benefit analysis and the political judgment an initial affordability decision can be made and projects can be prioritized against each other. The cost-benefit evaluations and the ranking of different projects should be made available to the public to encourage debate about what large infrastructure projects are the most important. The investment decision should be separate from the decision as to how to procure and finance the specific project. To strengthen prioritization between PPPs and traditional infrastructure procurement within the budget envelope decisions should be based on a whole of life, present value, approach for both.

140. There should be no institutional, procedural or accounting bias either in favour of or against PPPs. Value for money should be the only test as to whether a particular project is procured by way of a PPP or through conventional procurement routes. By value for money is meant the optimal combination of quality, features and price, calculated over the whole of the project's life.

**6. *Carefully investigate which investment method is likely to yield most value for money. Key risk factors and characteristics of specific projects should be evaluated by conducting a procurement option pre-test. A procurement option pre-test should enable the government to decide on whether it is prudent to investigate a PPP option further.***

141. Once the government has decided to move forward with the investment, a project should be subjected to a procurement option pre-test. This should guide the government in selecting which mode of procurement is likely to deliver the most value for money. The following elements should be included in such an examination and thereby indicate to the policy maker whether it is worthwhile to investigate the PPP procurement option.

- What are the comparative costs of (a) finance (b) construction (c) operation, as calculated over the whole lifetime of the project, in each alternative mode of procurement?
- Can the risks of the project be clearly defined, identified and measured?
- Can the right types of risk be transferred to the private partner to ensure value for money?
- Does the project involve any transfer of risks onto other stakeholders, including workers and local communities?
- Is the risk appetite and capacity of potential private-sector partners sufficiently robust to explore a PPP?
- What is the potential level of competition in the market? If competition is lacking, is the market contestable?

- Is there sufficient market interest in the project to generate a robust competition that will ensure a value for money outcome?
- How large are the whole of life benefits from combining the construction and the operating phases of a project in one contract?
- What is the risk of project failure associated with similar PPPs? What are the costs to the public authority associated with such failures?
- What contingent liabilities are associated with the project?
- Can the risks, cost and quality trade-offs be quantified and managed by the public sector?
- Can the desired project output be specified clearly ex ante? Is the planned project operating in a rapidly changing policy or demand environment? Are the underlying assets to be used to deliver the output in an area subject to rapid technological change?
- Is the potential PPP project of a size sufficiently large to justify the transaction costs?
- Who will make the contractual payments to the private-sector partner? Can some or all of the payments come from end-user charges?
- If end-user charges are levied Is demand sufficient over the lifetime of the project to ensure that the private partner generates the revenue required for it to maximise its profit? Might the potential private-sector partners accept demand risk in addition to availability risk?

142. If relevant, further analysis regarding using a PPP should be based on input from a prudent Public Sector Comparator, or an equivalent to compare value for money across options, especially when operation is an important component of the project. There are different methods used to assess the relative value for money of the different delivery models. In principle a Public Sector Comparator compares the net present cost of bids for the PPP project against the most efficient form of delivery according to the output specification by conventional public sector means (the so-called reference project). The public sector comparator serves as a hypothetical risk-adjusted cost of public delivery of the output specification of a PPP project. The methodology for preparing the public sector comparator should be published.

**7. *Transfer the risks to those that manage them best. Risk should be defined, identified and measured and carried by the party for whom it costs the least to prevent the risk from realising or for whom realised risk cost the least.***

143. After the fundamental assessment of specific issues and comparative costs, the key element in the decision to use PPPs is the transfer of risk from the government to the private partner. Risk is defined, identified and measured, and either retained by the public sector or transferred to the private partner through specific contract terms and an appropriate payment mechanism. Risk should be allocated where it can be best managed. By 'best' managed is meant the party for whom it cost the least to prevent the risk from realising, or for whom it costs the least to deal with the consequence of realised risk.

144. Risk should not be transferred to the private partner at any price for the sake of transferring risk alone or to achieve a desirable accounting treatment. Governments and public authorities cannot transfer to the private sector the risks associated with statutory responsibilities to maintain services.

145. An essential question is whether the risks of the project can be defined, identified and measured. The less this is the case, the more room there is for conflict over the contract, particularly when the risk realises. Potential private partners might also be unwilling, for an acceptable price, to take on risks that are not clearly defined, identified and measured. There should be clear methods in the contract by which risks

can be apportioned when they materialize. This is particularly important in cases where risk is difficult to measure.

**8. Value for money should be maintained during operation, renegotiation and exit. Events that may undermine the project need to be examined carefully to establish whether they are unforeseen or realisation of risk. Any re-negotiation should be made transparently and subject to the ordinary procedures of PPP approval.**

146. By monitoring and liaising with the private contractor, the public sector needs to maintain a project's value for money throughout its operation. The original risk transfer and contract terms should be maintained and care should be taken to make sure that the standards to which the private-sector contractor operates are not eroded without compensation to the public-sector authority.

147. Nonetheless, in some cases the assumptions underlying the project may turn out to be wrong and in extreme cases this can lead the project towards failure. As the public sector has an interest, sometimes a statutory responsibility, in making sure the asset keeps operating smoothly, a re-negotiation should take place to investigate possible solutions. However, even if the current project outcome differs from what the private partner expected, it may just be a realisation of the risk that it carried. Both parties need to distinguish between the realisation of risk and a genuine unforeseen change in circumstances. Only if conditions change due to discretionary public policy actions (i.e., "actions of the Principal") should the government consider compensating the private sector. Any other compensation for changes in commercial conditions should be explicitly negotiated within the contract. Otherwise, the risks to re-negotiations of PPP contracts due to changes in international conditions not foreseen at the moment of the contract award could significantly increase fiscal costs of PPPs for the government.

148. Furthermore, any re-negotiation that substantially alters the original agreement should be made public and be subjected to approval by the authority responsible for approving PPPs. Such an agreement should be as competitively as possible.

149. Particular attention should be paid to contractual arrangements and monitoring capacity at later stages of a project so as to ensure that incentives do not deteriorate as the cost of non-compliance falls.

**9. Value for money requires sufficient competition. The government should ensure there is sufficient competition in the market by a competitive tender process and by possibly structuring the PPP program so that there is an on-going functional market. Where competition is absent, once the contract has been awarded, the market should at least be contestable.**

150. Competition helps ensure the effective transfer of risk, that optimal solutions are developed by the private sector and that keenest pricing is tendered. There should be competition in the market, or in the absence of competition, the market should be contestable. A competitive market is necessary when tendering for PPP bids, but also once the contract has been concluded and the PPP is operational. This is particularly important in cases where the PPP subsequently becomes a monopoly provider in a certain area. It can therefore be beneficial to structure a PPP program to ensure an on-going functioning market, possibly by the separation of services and by having a number of regional projects rather than a single national one. In markets where competition is absent after the award of the contract, the market should at least remain contestable – thus, the private partner should know that there is always the possibility of alternative private partners entering the market.

**C. Use the budgetary process transparently in order to minimise fiscal risks and ensure the integrity of the procurement process**

***10. In line with the government's fiscal policy the Central Budget Authority should ensure that the project is affordable and the overall investment envelope is sustainable.***

151. PPPs, as well as conventional long-term government borrowing for investment, are more difficult to integrate with the annual budget process than more ordinary variable expenditures that can be modified from year to year. This makes affordability assessments particularly important when the project is being prepared. An investment project is affordable if the expenditure and contingent liabilities it entails for the government can be accommodated within current levels of government expenditure and revenue and if it can also be assumed that such levels will be and can be sustained into the future. The investment expenditure budget, including an assessment of contingent liabilities, should be based on medium and long-term fiscal projections and regularly updated. Limits on stocks and flows of PPP, while not a substitute for medium-term planning, can help contain fiscal costs and limit overall public sector long-term commitments to levels that are fiscally affordable. This applies to the overall public sector, regardless of the level of government from which the fiscal costs originated.

152. To secure affordability and project quality the Central Budget Authority should scrutinize each PPP. The Central Budget Authority should check and monitor the PPP through each key phase: Planning; Feasibility, Design and Tender Preparation; Bidding and Contract Signing; and Construction and Operation. The Central Budget Authority should scrutinise the project for value for money, affordability, procedural steps and that the projects remain in line with political agreements.<sup>11</sup> While the Central Budget Authority need not possess deep and specific knowledge of the PPP project's technical design, it needs sufficient capacity to evaluate the documentation presented to it. The Central Budget Authority should assure that capital investments are aligned with the government's short and medium term macroeconomic stability targets.

***11. The project should be treated transparently in the budget process. The budget documentation must disclose all costs and contingent liabilities. Special care should be taken to ensure budget transparency of PPPs covers the whole public sector.***

153. Budget documentation must transparently disclose all information possible regarding the costs and contingent liabilities of the PPP. The information should include what and when the government will pay, and full details of guarantees and contingent liabilities. The payment stream from the government under the PPP contract should be highlighted, particularly if they are back loaded. Preferably the information should be disclosed at the same time as the results of the long-term fiscal analysis that shows the long-term effects of the stock and new flow of PPP contracts. The treatment of PPPs should conform to The OECD Best Practices for Budget Transparency (OECD, 2002).

154. A particular challenge for the prudent and transparent usage of PPPs is the application of this tool outside of the general government but within the public sector, in particular state owned enterprises (SOEs). SOEs can engage in PPP-type of arrangements that often, but not necessarily, require explicit, or implicit, guarantees from the central government. SOEs may have long-term obligations to purchase goods and services from the private sector, such as power and water purchase agreements. As these obligations in general are not included in the definition of public debt they may not be properly monitored by the central government. However, given the political importance of the provided services the central government might very well be expected to assume some financial responsibility if needed. This may require that the

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11. See also IMF (2008).

Central Budget Authority actively monitors and mandates the use of PPP-like arrangements in the Public Sector at large.

155. Where the central government has the relevant constitutional authority it should consider allowing sub-national governments to prudently use PPPs. If there are implicit or explicit central government guarantees to sub-national government levels, PPP activity must be controlled through rules on PPP stocks and flows. The Ministry of Finance should retain an up-to-date overview of all PPP liabilities relevant for the central government. Given the fact that sub-national governments are less likely to accumulate a critical mass of projects over time the central government should consider ways of leveraging its management capacity regarding PPPs to the benefit of sub-national governments.

***12. Guard against waste and corruption by ensuring the integrity of the procurement process. The necessary procurement skills and powers must be made available to the relevant authorities.***

156. Enhancing integrity necessitates recognising the risks inherent throughout the entire procurement cycle, developing appropriate management responses to these risks, and monitoring the impact of mitigating actions. PPP procurement should be a strategic profession, informed by an understanding of relevant commercial principles rather than a simple administrative process within a public organisation. This transformation necessitates developing knowledge and creating tools to support improved procurement management decision making. Enhancing integrity in public procurement must be placed within the broader management goals of the public sector as discussed in the 2008 OECD Principles for Enhancing Integrity in Public Procurement.

157. As is obviously clear from the above discussion the recommendations cover a great deal of ground and some of the elements are more important than others in particular contexts. In addition, some are treated elsewhere in this report such as competition, the governance of regulators. In the following part the issues relevant for Indonesia are highlighted.

## APPENDIX 2

### THE GATEWAY PROCESSES IN SOUTH AFRICA, VICTORIA (AUSTRALIA) AND KOREA<sup>12</sup>

#### South Africa

158. The project procurement cycle is divided into six phases: inception, feasibility study, procurement, development, delivery and exit (see Table 5 below). According to the Public Finance Management Act, the heads of national and provincial departments (accounting officers) and the boards of public entities (accounting authorities) are responsible for implementing of public-private partnership projects. They are directly responsible to the Parliament/elected legislature and need to evaluate the value for money. During this process, the National Treasury gives “Treasury Approvals” at different stages of the public-private partnerships procurement cycle: after the feasibility study, procurement, and value-for-money report, and when the project agreement management plan is finalised. Typically procurement timelines range from 41 weeks (ten months) to 103 weeks (approximately two years).

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12. This appendix is adapted from OECD (2010).



**Table 5. Public-private partnership procurement cycle in South Africa**

Phase	Description
Phase 1: Inception	The accounting officer/authority registers the proposed project with the National Treasury PPP Unit. The accounting officer/authority appoints a project officer and the PPP Unit will appoint a project advisor.
Phase 2: Feasibility study	The accounting officer/authority conducts a project feasibility study including a needs analysis, solutions options analysis, project due diligence assessment and a value assessment. An economic valuation may also be required.
	The project team prepares a project procurement plan, including a project timetable, availability of funds, list of potential challenges, project stakeholders, project team, bid evaluation process, list of required approvals.
Treasury Approval I (Feasibility Assessment)	The project team submits the feasibility report and project procurement plan to the National Treasury PPP Unit for approval prior to preparing the bid documents and draft project agreement.
Phase 3: Procurement	The project team and project officer must prepare the request for qualification documents.
Treasury Approval IIA (Request for Qualification documentation)	Request for Proposal submitted by the project team to the National Treasury for approval.
Phase 3: Procurement (cont.)	The request for qualification is published and the submissions evaluated by the project team against the project documents to select a list of pre-qualified bidders to participate in a request for proposal.
Treasury Approval IIB (Request for Proposal documentation)	The request for proposal and the draft PPP agreement are submitted to the Treasury for approval.
Phase 3: Procurement (cont.)	The request for proposal is sent to pre-qualified bidders to prepare their bids. Upon receipt of the bids the project team evaluates them. This involves technical evaluation, evaluation by the Evaluation Co-ordination Committee and the Project Evaluation Committee.
Treasury Approval III	Once the PPP agreement is negotiated, legal due diligence is completed and approval is granted, the project team must request "Treasury approval III.
Phase 3: Procurement (cont.)	Proposal together with the draft PPP project agreement is published and the bids evaluated against the feasibility study to select a preferred bidder by the project team.
Phase 4: Development	
Phase 5: Delivery	The project team manages performance of the project to ensure the project remains affordable and is in accordance with the project agreement.
Phase 6: Exit	The project team assesses the project deliverables, integrates lessons from the partnership and prepares a post-implementation review.

### **Victoria (Australia)**

159. Table 6 outlines the procurement cycle for public-private partnerships in Victoria. It identifies the responsibility of procuring government agencies, Partnerships Victoria and the different gateway review teams.

160. The procurement process is conducted in line with the government's Gateway Initiative. The initiative is a government-wide project led by the Victoria Department of Treasury and Finance to improve the selection, management and delivery of infrastructure and ICT projects in the State of Victoria. A core element of the initiative is the "gateway reviews" to help government departments and agencies to align investment with the government's strategic and value-for-money objectives. Gateway reviews are

conducted by a team of experts, independent of the project team. In total there are five gates, or key decision points, that are assessed by an independent gateway review team in the preparation of public-private partnership projects: strategic assessment, business case, readiness for market, readiness for service and benefits evaluation.

161. The strategic assessment review examines whether or not proposed projects are the best value means of servicing the identified need and whether it aligns with government and relevant departmental or agency strategic plans. The business case review considers whether or not the project options have been fully canvassed and evaluated, whether or not the recommended option is the best value solution. The procurement strategy review questions whether or not the optimum method to deliver the project has been selected in consideration to budget and time constraints, as well as appropriate allocation of project risks to those best able to manage them. The readiness for service review assesses the state of readiness to commission the project and implement the change management required. All together, the procurement process, from project planning to the beginning of contract execution, can extend for two to two and a half years (Victoria Department of Treasury and Finance, 2006). The final gateway is a benefits evaluation to assess whether or not the expected benefits, as outlined in the business case, were achieved and the findings communicated to improve future projects.

162. During project preparation, the procuring government organisation prepares the business case and constructs a public sector comparator, including the development of output specifications and a reference project. The procuring agency is also responsible during contract management to establish and maintain a robust contract management framework throughout the contract term to successfully deliver the project objectives. This includes establishing appropriate governance structures and effective communication and reporting lines; ensuring that all relevant project staff undertake appropriate training within six months of their appointment; systems to ensure the continuity and retention of project knowledge over the life of the project; risk and dispute mitigation and their reporting; and regular ongoing review of its contract management practices to identify outstanding and emerging issues and take into account recent and anticipated future developments.

163. In addition, Partnerships Victoria assists procuring agencies to develop preliminary costing for the main public sector comparator components and review of the preliminary public sector comparator as part of the business case. Partnerships Victoria supports and reviews the contract management, including assisting in risk mitigation and dispute resolution; facilitating knowledge sharing of contract management, including conducting forums for contract managers to share lessons learned and networking with their peers; establishing and implementing professional training programmes for public sector contract directors/managers; and monitoring and independently advising the Treasurer and Cabinet on significant contract management issues.

**Table 6. Key approval steps in PPP procurement for government agencies**

	Responsibility
Identification of proposed project	Government agency
Development of business case, procurement option analysis, together with preliminary public sector comparator and public interest test.	Government agency
Gate 1 (Strategic Assessment): Review of initial project development, business case and procurement options analysis, preliminary public sector comparator and public interest test.	Gateway Review Team
Gate 2 (Business Case): Review of business case and procurement options analysis, preliminary public sector comparator and public interest test.	Gateway Review Team
Government approval of project and procurement method based on the business case and public interest test and the procurement options analysis.	Government agency
Approval of release of expressions of interest.	Government agency
Gate 3 (Readiness for Market): approval of the public sector comparator (may be earlier than this point).	Gateway Review Team
Approves release of request for proposals and evaluation of responses by project team.	Government agency
Approval of contract execution note and financial close (within three months of financial close).	Government agency
Approval of project contract summary (within three months of financial close).	Government agency
Gate 5 (Readiness for Service): the portfolio minister in consultation with the Treasurer approves the Contract Administration Plan (within three months of financial close).	Gateway Review Team
Ongoing requirement for material contract variations to be considered and approved.	Subject to existing delegation authority
Gate 6 (Benefits Evaluation): One or more benefits evaluation reviews should be conducted by the procuring agency, in consultation with the Department of Treasury and Finance.	Gateway Review Team

*Notes: Public-private partnership projects are not subject to Gate 4 reviews (tender decisions) in accordance with the Gateway Review Process.*

*Source: Department of Treasury & Finance (2009), National PPP Guidelines: Partnerships Victoria Requirements, Department of Treasury & Finance, Melbourne.*

164. Partnerships Victoria is, however, not responsible for the gateway reviews; this is done by an independent team, comprising three or four people, appointed by the Department of Treasury and Finance. The review team is selected according to each project's needs and to provide a mix of skills, knowledge and experience. The team should possess project-relevant skills and experience in its current phase in the procurement cycle, and knowledge and understanding of the project's industry sector as well as knowledge of government processes such as the gateway review. Gateway review teams are appointed to be independent from the project, and in the case of high-risk reviews, the independence of the review team from the department is the key to delivering objective, high-quality reviews and reports.

## **Korea**

165. Table 7 outlines the procurement cycle for public-private partnerships in Korea. It distinguishes between build-transfer-lease and build-transfer-operate projects, and between solicited and unsolicited build-transfer-operate projects. It identifies the responsibilities of the procuring line ministries/local governments (the competent authority), the Ministry of Strategy and Finance and PIMAC. Reference to the Ministry of Finance and Strategy in the table includes both the PPP Review Committee where decisions

are required and the Economic Budget Bureau of the Budget Office to factor decisions into the state budget.

166. PIMAC is involved in the procurement process of all projects – build-transfer-lease and both solicited and unsolicited build-transfer- operate. It reviews the value-for-money tests prepared by competent authorities for all build-transfer-lease projects and solicited build- transfer-operate projects that exceed KRW 20 billion. Under the PPP Act, PIMAC is entitled to conduct value-for-money tests for all unsolicited projects. PIMAC submits the result of the test for the private proposal with its opinion to the concerned ministry/local government and the Ministry of Strategy and Finance. If the concerned ministry/local government decides to proceed with the project based on the result of the value-for-money test, it must notify a request for alternate proposals to invite other private parties for competitive bidding. The other steps in the procurement process are broadly similar to solicited projects. PIMAC is not, however, responsible for designation of a project as a public-private partnership.

**Table 7. The role of PIMAC in the PPP procurement cycle in Korea**

Stage	Build-transfer-lease projects	Build-transfer-operate projects	
		Solicited	Unsolicited
Identification of proposed project	Competent authority (1)	Competent authority	Private sector
Preliminary feasibility study, if applicable (2)	PIMAC	PIMAC	PIMAC
Determination of aggregate investment ceiling for project	MoSF	n/a	n/a
Feasibility/Value-for-money test	Competent authority reviewed by PIMAC	Competent authority reviewed by PIMAC (if > KRW 20 billion)	PIMAC
Approval by National assembly	MoSF to National Assembly for approval	n/a	n/a
Designation as PPP project (3)	Competent authority	Competent authority	Competent authority
Announcement of request for proposals (for solicited projects) or alternative proposals (for unsolicited projects) (3)	Competent authority	Competent authority	Competent authority
Submission of project/alternative proposals (if applicable)	Private sector		
Evaluation and selection of preferred bidder	Competent authority		
Negotiation and contract award (designation of concessionaire) (4)	Competent authority with preferred bidder. Input may be solicited from PIMAC		
Application for approval of Detailed Implementation Plan	Concessionaire to the competent authority		
Construction and operation	Concessionaire		

Notes: MoSF = Ministry of Strategy and Finance; PIMAC = Public and Private Infrastructure Investment Management Center

1. Competent authority refers to procuring line ministries/local governments.
2. A preliminary feasibility study is required under the National Fiscal Act for investment projects that exceed a certain threshold size. A preliminary feasibility study is required: if the proposed public-private partnership project costs more than KRW 50 billion and requires a central government subsidy of more than KRW 30 billion.
3. Deliberation by the PPP Review Committee is required for build-transfer-lease projects that exceed KRW 100 billion and build-transfer-operate projects that exceed KRW 200 billion.
4. Deliberation by the PPP Review Committee on a concession agreement and designation of a concessionaire is required for build-transfer-lease projects that exceed KRW 100 billion and build-transfer-operate projects that exceed KRW 200 billion.

Source for table: Authors' notes.

**APPENDIX 3**  
**FUNCTIONS OF GOVERNMENT ORGANISATIONS, FINANCE MINISTRIES AND PPP UNITS**  
**IN THE PROCUREMENT CYCLE**

**Table 8. Functions of government organisations, finance ministries and dedicated PPP units in the procurement cycle**

	Korea			Germany			South Africa		United Kingdom			Victoria	
	Procuring govt organisation	Ministry of Strategy and Finance	PIMAC (dedicated PPP unit)	Procuring govt organisation	Federal Ministry of Finance	Partnerships Germany (dedicated PPP unit)	Procuring govt organisation	National Treasury PPP Unit	Procuring govt organisation	HM Treasury	PPP Policy Team (dedicated PPP unit)	Procuring govt organisation	Partnerships Victoria (dedicated PPP unit)
<b>Pre-tender</b>													
Project initiation	●(1)	-	-	●	-	-	●	●	●	●	○	●	●
Assess feasibility and VfM	●	○	●	●	●	○	●	●	●	○	●	●	●
Budgeting	●	●	-	●	●	○	●	○	●	●	-	●	●
Project approval	●	●	○	-	●	○	●	●	●	●	●	●	●
<b>Tender</b>													
Invitation to tender	●	●	-	●	-	○	●	○	●	-	-	●	-
Bid evaluation	●	-	○	●	-	○	●	○	●	-	-	●	-
Negotiation	●	-	○	●	-	○	●	○	●	-	-	●	-
Bid approval	●	-	-	●	-	○	●	●	●	-	-	●	-
<b>Post-award</b>													
Contract management	●	○	-	●	○	○	●	○	●	-	○	●	○
Payment oversight	●	○	-	●	○	○	●	○	●	○	○	●	○

Notes:

● = direct responsibility, ○ = indirect responsibility, - = not applicable

1. Korea: May also come from private sector (unsolicited) public-private partnership.

Source: OECD (2010)

#### APPENDIX 4 DEFINING VALUE FOR MONEY<sup>13</sup>

167. As mentioned in the introduction, the concept of value for money includes both qualitative and quantitative aspects. In addition, it typically involves an element of judgment on the part of a government. As such, a precise indicator to measure value for money does not exist. Value for money can broadly be defined as what a government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime.

168. The typical definition for value for money found in the literature defines it in terms of three elements: economy, efficiency and effectiveness (Diamond, 2005:162). Economy is the minimisation of the costs of inputs, while efficiency is the minimisation of inputs for a given set of outputs, or the maximisation of outputs for a given set of inputs. Efficiency entails both technical and economic efficiency. Technical inefficiency, also known as X-inefficiency, refers to when resources are not technically employed in the best way; it usually means that the levels of some inputs can be reduced while still delivering the same outputs (Diamond, 2005:161). A typical example is over-staffed programmes where the level of staff can be reduced without any need to reduce output levels. Economic inefficiency results from the combination of inputs that is not optimal given the relative prices of inputs. Usually, different combinations of inputs can deliver the same level of output (e.g. one might substitute teachers for computerised teaching aids or *vice versa*). However, given the relative prices of inputs, only one of these combinations will minimise cost. Therefore, if by changing the combination of inputs the cost of delivering a service can be lowered, the new combination will represent an improvement in economic efficiency. Economic efficiency is maximised when no further cost reductions can be made by altering the composition of inputs. Effectiveness refers to the impact of policy, *i.e.* whether or not the outputs reached (e.g. a certain teacher/pupil ratio) deliver the desired outcome (improvements in educational attainment as measured by indicators such as throughput rates). According to Diamond (2005:163), there are two forms of ineffectiveness: technical and economic. Even when delivery of a service is technically and economically efficient, the service itself may technically fall short of addressing the needs it was designed to address. It is then said to be technically ineffective. Economic ineffectiveness exists when the overall effectiveness of public resources can be improved by reallocating resources.

169. The above argument is sometimes summarised as:

- Economy in the use of resources: maximise inputs per dollar, euro, pound, yen, etc.
- Efficiency: maximise outputs per input.
- Effectiveness: maximise outcomes per output.

170. Following from these three components, the maximisation of value for money is defined as the maximisation of outcomes with respect to every dollar, euro, etc., spent on inputs. This is only possible if outcomes are maximised with respect to outputs (effectiveness) and if outputs are maximised with respect to inputs (efficiency), which in turn are maximised with respect to every dollar, euro, etc., spent on the inputs (economy).

171. Although appearing straightforward when stated as ratios to be maximised, such an appearance is deceptive. Defining value for money in terms of outcomes per dollar, euro, etc., spent on inputs addresses only supply-side efficiencies and effectiveness, while leaving out demand-side efficiency. Demand-side efficiency is more commonly known as allocative or Pareto efficiency. This form of efficiency might be

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13. This appendix is adapted from Burger and Hawkesworth (2011).

the most difficult to measure, but it is nevertheless key to whether or not a service really represents value for money. When considering value for money, the question is “value for whom?” Presumably the answer is not government, but the recipient of the service/taxpayer.<sup>14</sup> As in private goods markets, allocative efficiency refers to the allocation of consumers’ purchasing power to various goods and services in a manner that will maximise their welfare (utility). Thus, it refers to the welfare of those receiving a service. An improvement in allocative efficiency can be attained if one can improve the welfare position of one agent (i.e. recipient of the service) without causing a deterioration in the welfare position of another agent. This is attained by reallocating resources spent on services so as to deliver the quantity and quality of different types of outputs (with the desired output features) that will maximise welfare. When no reallocation can improve the welfare of one agent without causing a deterioration in the welfare of another, the allocation of resources is said to be allocatively or Pareto efficient.

172. Unfortunately, the welfare that individuals derive from consuming goods and services cannot be measured directly. In a private goods market this is not a problem, because individuals are forced to translate the welfare that they expect from consuming a good into a demand for that good (they are said to “reveal their demand”). However, many of the goods that governments deliver suffer from the free-rider problem, which means that demand (and therefore what will maximise welfare) is not revealed. Therefore, it is possible that a service is delivered in a technically efficient way, also reaching all output and outcome goals, but that it is not something society wants and thus wanted to allocate resources to. This renders the service allocatively inefficient and hence also means that, even though all output and outcome objectives might have been reached (supply-side efficiency and effectiveness), the service nevertheless represents no or limited value for money (because it lacks demand-side efficiency). This situation is of course aggravated by budgetary constraints that require the government to set priorities and to trade off the benefits and welfare improvements of different spending programmes.

173. In essence, the problem is that the composition of goods that will maximise welfare can only be approximated by voters revealing their preferences in elections – an approximation that is quite imperfect at times, as the public choice literature has demonstrated. In addition, allocative efficiency depends on demand, which in turn depends (among other things) on wealth and income. Thus, should the government also pursue redistributive goals, it will indirectly affect the allocative efficiency of its programmes and hence render the decision as to what constitutes value for money even more difficult.

174. All of the above discussion serves to indicate that what constitutes value for money is not just a quantitative exercise. Because of all the difficulties highlighted above, what constitutes value for money usually also requires a significant level of qualitative judgment on the part of the government. A government needs to judge the unrevealed demand for different services. Thus, it needs to judge what are the appropriate services to deliver and, in the case of each service, what will constitute the optimal combination of quantity, quality and features. It then needs to deliver these services with economy, technical and economic efficiency, and technical and economic effectiveness.

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14. Discussing value for money only in terms of the supply-side efficiencies and effectiveness might also explain why some critics of PPPs base their comments on a criticism of the value-for-money concept. Ignoring the demand-side efficiency might create the impression that the answer to the question “value for whom?” is government. To include demand-side efficiency refocuses attention on whom policy is ultimately designed for: the taxpayer/voter/citizen.



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