Rationale and Options for an Infrastructure Guarantee Fund in Indonesia

February 19, 2007

1 Introduction

The Government of Indonesia wishes to promote public private partnerships (PPP) in infrastructure. In principle, the government can increase its own borrowing, and invest in more public infrastructure—why then consider PPPs? The reasons are two-fold:

- First, PPPs can improve efficiency and reduce infrastructure costs by harnessing private sector incentives. PPPs increase efficiency because they shift some risks to private firms
- Second, PPPs can also attract private capital, which under some circumstances, may be cheaper than the government’s own borrowing costs. The cost of private capital will depend on the risks faced by the project.

The government will need to provide private investors with guarantees against certain risks, both to make projects bankable and to reduce the cost of finance. In theory, the process for providing government guarantees is straight-forward. The government would evaluate and quantify risks associated with a project, decide which risks it should cover, and then consider the fiscal costs of guaranteeing those risks against other expenditure priorities.

In reality, however, risk analysis is an art rather than a science. Experience shows that it matters who undertakes evaluation of project risks and what their incentives are. It is also not practical to evaluate support for each individual project against all other spending priorities. Overall, the institutional setting within which resources are allocated to the support of PPP projects and decisions about risks are made can make a big difference to the quality of the PPP program and the costs to the tax-payer.

This paper discusses the creation of a Guarantee Fund as an institutional solution to the practical problems faced by the Government in offering and administering these guarantees. We also discuss a menu of institutional arrangements for establishing such a Fund, should the Ministry of Finance decide to proceed.
2 Objectives of a Guarantee Fund

While there are a number of institutional options for the setting up of a Guarantee Fund, the key attribute is some degree of operational independence from the Government, and a separate balance sheet which would insulate the Fund from year-on-year changes in fiscal policy. In deciding whether it is worth setting up a Guarantee Fund, the Government needs to consider what benefits can be derived from such organizational independence. The benefits need to be compared to the alternative of the Government issuing guarantees through the Ministry of Finance, with the assistance of the Risk Management Unit.

In this section we consider the possible benefits of a Guarantee Fund.

2.1 Reduce the cost of PPPs

The Guarantee Fund can reduce the cost of finance for PPP projects if the guarantee provided by the Fund is more credit-worthy than the guarantee provided by the Government directly through the Ministry of Finance. This can happen if the Guarantee Fund has a higher credit rating that the Government itself. In other words, its promises would be more credit-worthy. How would that be possible?

- First, this would happen if the Guarantee Fund is endowed with an asset base, and the Fund has strong procedures to ensure that the expected value of liabilities matches the expected value of its assets. As a separate entity, the Fund would be insulated from broader fiscal risks.
- Second, the Guarantee Fund can be backstopped by an AAA-institution, such as the World Bank. Again, the value of the backstop derives from the Fund having financial independence from the Government. For example, the backstop could be in the form of a contingent loan, which is disbursed in the event that cash-flow is required to meet a guarantee call. In theory, the Government could contract a contingent loan directly, and disburse it through the Ministry of Finance. But if the loan was part of the Government’s overall fiscal envelope, the credit-worthiness of the guarantee would still be limited by that envelope.

A further aspect of credit-worthiness, from the point of view of a PPP project sponsor, is the timeliness of payment, and the risks of conflict associated with enforcing contractual obligations. A separate Guarantee Fund could settle obligations more promptly because it would not have to secure annual budget appropriations. Project sponsors may also feel that a dispute with or legal action against such a Fund is less risky than being involved in a conflict with the Government.

2.2 Give the Government Greater Certainty

PPPs create fiscal risks for the Government. Shifting PPP liabilities to a separate entity with limited liability can ensure there are no hidden risks in the Government accounts. The Government’s exposure is limited by its equity in the fund.

Of course, it is important to understand the limits of such separation. In theory, if the Guarantee Fund provides guarantees in excess of what it can honor, the Government can let the Fund fail. In practice, this may not be politically feasible. This is why the IMF is skeptical about such institutional separation, and tends to look for consolidation of Government accounts.
However, if the guarantee fund is properly governed, and is operated prudently, the Government will enjoy greater, albeit not perfect, certainty. Over time, if private investors are brought into the Fund, the separation between the Government and the Fund can be deepened, and hence the Government would gain more certainty.

2.3 Improve Incentives for PPPs

One of the key risks for the Government in implementing a PPP program is that PPPs may be procured for wrong reasons. One wrong reason is cost-shifting. Spending ministries may promote PPPs because Government obligations under such contracts do not come out of their budgets, but are approved under a separate budget appropriation by the Ministry of Finance.

Another wrong reason for PPPs is to avoid the scrutiny involved in securing government subsidies. For example, if the Government wants to build a toll road in an area where there may not be sufficient traffic to make such a road viable, it would need to subsidize tolls. However, such explicit applications for subsidies are politically difficult. Project promoters have another option: they can construct over-optimistic traffic forecasts, and then ask the Government for a minimum revenue guarantee. Such a guarantee – because it is almost certain to be called upon – is as good as a subsidy, but it is politically less visible, does not need to be reflected in this year’s budget, and is easier to secure.

The Government can address these problems through internal review procedures. For example, the KKPPI process, together with the RMU review, is jointly designed to weed out such inappropriate proposals. In practice, however, such internal review processes do not always work well and are subject to political pressures.

A Guarantee Fund can add to the Government’s armory of devices for ensuring the quality of the PPP program. A separate entity with commercial governance and with a base of assets which it will want to protect will have more incentive to identify true risks of projects. For example, if the Fund has a management contract with a reputable firm, such a firm will want to protect its brand in undertaking project reviews, and will be less subject to political pressures or to being captured by line ministry interests.

2.4 Attract Necessary Skill

A Fund set up as an SOE will be able to pay more market-related salaries than a Government body, and hence will be better able to attract staff with the necessary skills. Also, through a management contract with a reputable financial institution, such a Fund can improve staff performance incentives by tying performance to remuneration.

2.5 Promote PPPs and Leverage Experience

Organizations responsible for providing guarantees for PPPs face conflicting objectives: on the one hand, they have to be prudent, and to make sure they do not take on unnecessary risks. On the other hand, they need to help promote appropriate PPPs, which may not otherwise happen. For example, RMU in the Ministry of Finance is caught in a bind: it appropriately sees its first job as being the fiscal guardian, but it runs the risk of being seen as the bottleneck in the PPP program.

A specialist Guarantee Fund may have better incentives to resolve this conflict. For example, it is possible to prepare a management contract which would ensure that the management team is remunerated best if it appropriately balances the risks and helps make deals happen.
This would happen if performance pay is dependent both on closing deals and on meeting prudential requirements.

As we discuss later in this note, the Guarantee Fund would initially be created in the context of the national PPP program. It would not have the resources – both human and financial – to deal with more than that. However, once the institution is established, and has a track record of successful transactions, it can apply the same experience to sub-national deals, both local government PPPs and PPPs involving SOEs (such as PLN IPPs).

3 Time Horizon

The previous section considered the full range of objectives which the Guarantee Fund can help achieve. However, the objectives differ in their significance, in the time frame during which they can be achieved, and in their relative priority in the short term. Table 1 summarizes priority and time horizon over which the benefits from having the Guarantee Fund as a separate entity.

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Short Term Priority</th>
<th>Time Horizon</th>
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<tbody>
<tr>
<td>Reduce PPP costs</td>
<td>Medium</td>
<td>Possibility of triple-AAA backstop in the short-run</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Fund’s credit-worthiness established over time</td>
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<tr>
<td>Greater certainty</td>
<td>Medium</td>
<td>Initial improvement from creation of separate entity</td>
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<td></td>
<td></td>
<td>Credibility of risk evaluation and independence from Government will take time to establish</td>
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<tr>
<td>Improve incentives for PPPs</td>
<td>High</td>
<td>Immediately will give some protection from political pressures to support poor quality projects</td>
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<tr>
<td></td>
<td></td>
<td>Incentives can be strengthened over time</td>
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<tr>
<td>Attract necessary skills</td>
<td>High</td>
<td>Immediate ability to pay market salaries</td>
</tr>
<tr>
<td>Promote PPPs</td>
<td>High</td>
<td>Some benefit in the short term</td>
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</table>
3.1 Pipeline of PPP Projects

Understanding the likely demand for Government support is important when designing the Guarantee Fund. This section explains the types of infrastructure PPP projects that would most likely request a guarantee from the Ministry of Finance in the near future.

The Government’s plans with respect to PPPs are very ambitious. At the Infrastructure Summit held at the end of 2006, the Government announced that there are 25 PPP projects being prepared, with an estimated total investment of more than US$7 billion. In practice, however, only a limited number of projects will be ready to be procured within the next two years. For most of the 25 PPP projects announced by the Government, the feasibility studies are not yet completed. Hence, the Government cannot assess at this stage whether or not these projects are feasible, and if they are, what type of government support they require.

After the Infrastructure Summit, the Government announced that it will concentrate on 10 model projects that it considers “commercially viable and bankable”. These projects will be prepared according to the requirement of the PerPres 67, and the need for government guarantees will be assessed according to PMK 38.

The table below summarizes the 10 model projects and their estimated investment costs.

<table>
<thead>
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<th>Table 2: Summary of PPP Project Pipeline</th>
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<tr>
<td><strong>Key Features</strong></td>
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<tr>
<td>Central Java Coal Fired Power Plant</td>
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<tr>
<td>Pasuruan Combined Cycle Power Plant</td>
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<tr>
<td>Medan-Kuala Namu-Tebing Tinggi Toll Road Project</td>
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<td>Solo-Kertosono Toll Road Project</td>
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<td>Margagiri-Ketapang Ferry Terminal</td>
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<td>Teluk Lamong Seaport (Tanjung Perak Port Expansion)</td>
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<tr>
<td>Bandung Water Supply Project</td>
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<tr>
<td>Project Description</td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
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<tr>
<td>Dumai Water Supply Project</td>
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<tr>
<td>Tangerang Water Supply Project</td>
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<tr>
<td>National Telecommunications Backbone Project</td>
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</table>

Source: Castalia

The Pasuruan Combined Cycle Power Plant is a project which has serious gas supplies complications and unresolved legal claims. This project is unlikely to move ahead. The Central Java plant could be a feasible project. However, if it goes forward, it would most likely not apply to the Ministry of Finance for a direct guarantee. PLN plans to support it through a separate credit support arrangement agreed between the Ministry of Finance, JBIC and PLN. Hence, both electricity projects will not require direct government guarantees from the Guarantee Fund.

Water supply projects are not considered national level projects, as the responsibility for providing water supply is with the local governments. Under the current regulations for government support, there are no provisions for providing guarantees for sub-national level projects. Although water supply projects could greatly benefit from government support, the Guarantee Fund will not be able to provide a guarantee to these projects until and unless the policy is changed and a new decree is issued.

The proposed National Telecommunications project does not include a competitive tender. Therefore, it will not be compliant with the Perpres 67, and will not be able to access a government guarantee.

This brief review of project status suggests that in the next two to three years, requests for PPP support will primarily come from toll road and other transportation projects. Typically, transportation projects, especially toll road projects, require some level of government support with respect to land acquisition and demand. In addition to the Guarantee Fund, these projects are expected to benefit from the Land Acquisition Fund. Hence, over the next few years, the Guarantee Fund would most likely focus on decisions on demand (minimum revenue) guarantees for transportation projects.

In the short term, the benefits which could be derived from setting up the Guarantee Fund would be limited to a relatively small number of projects. Hence, it may pay not to be overly ambitious regarding the range of objectives that can be achieved initially, and the depth to which those objectives can be achieved.

The more objectives the Fund aims to achieve, the greater the organizational and political complexity. It may pay to start with a relatively simple concept for such a Fund, and to concentrate on the securing the main benefits.

The Guarantee Fund concept should also be seen in the context of a range of entities which the Government has established or is considering. The relationship between these facilities is discussed in the box below.
Box 1: Strategy for Financially Supporting PPPs

We understand that the Government is prepared to offer various forms of financial support to help promote PPPs. Three forms that have been announced are a Land Acquisition Fund, an Infrastructure Investment Fund and a Guarantee Fund.

The Land Acquisition Fund will deal specifically with the risks around land price and availability. The Infrastructure Investment Fund aims to create a vehicle which would enable infrastructure PPPs to access the domestic financial market in Indonesia, hence reducing finance costs. The Guarantee Fund will deal with residual relevant risks, which need to be covered for the project to become bankable.

When thinking about how to launch these support facilities—in sequence or in parallel—it is useful to consider the projects in the pipeline and the trends in the infrastructure finance market.

As discussed above, the majority of the projects that will require support from the Guarantee Fund in the near future are toll road and transportation projects. These types of projects are characterized by high land acquisition and demand risks—and their ability to raise capital on a project finance basis depends on the Government’s willingness to share these risks. This suggests that to make these projects happen it makes sense for the government to establish a facility like the Land Acquisition Fund to share land acquisition risk; or like the Guarantee Fund to share the demand risk.

Creating a mechanism for mobilizing long-term financing for infrastructure projects from the domestic capital markets is a step in the right direction towards increasing infrastructure development. Finding and preparing infrastructure projects that represent good investment opportunities, however, is more challenging than finding capital willing to be invested.

We are observing in the international private infrastructure market a mismatch between capital offers and demand for this capital. International investors and lenders fiercely compete to place their capital in a limited number of good infrastructure investment opportunities. For example, in the recent sale of Mirant’s power generation assets in the Philippines, we observed how the winning consortium offered a price of $3.4 billion for 2,200MW of coal-fired capacity—an amount that exceeded by at least $700 million the offers of other bidders. This suggests that mobilizing capital is not as challenging as finding good projects.

On balance, facilities to make projects bankable—such as the Land Acquisition Fund or the Guarantee Fund—are a higher priority than facilities aimed at mobilizing capital directly.

Source: Castalia

3.2 Guarantee Fund Concept over Time

The analysis of the project pipeline suggests that there is short-term need for a facility which would help make toll road projects bankable. To proceed quickly, it is important to make the institutional structure as simple as possible. At the same time, the initial focus on the relatively small number of projects suggests that it is not worth developing a structure which, from day one, can address a broad range of PPP issues.

In this section, we consider the Fund concept which would fit within the existing decision-making and procedural modes. Such a concept can be readily implemented. To provide a context for such a concept, we also consider a more ambitious, long-term concept, which
would address a wider range of PPP issues, but would require a more significant change in the way the Government deals with the risks of PPP projects.

### 3.2.1 Relationship between the Fund and the Government

There are two alternative approaches to define the relationship between the Guarantee Fund and the Government:

- **The first is to consider the Fund as being responsible for the management of public funds, which have been allocated to the support of PPPs.** In other words, the Fund operates as a spending agency of the state, with a mandate to spend public funds for a particular public purpose. The Fund structure is designed to deal with the contingent and multi-year nature of PPP support. It will also allow higher salaries and facilitate better accounting.

- **The second is to consider the Fund as applying public capital to supply a service, which the Government wishes to be provided but for which the Government, and others, can be expected to pay market prices.** In this context, while the Fund’s services contribute to the achievement of the Government’s policy objectives with respect to PPPs, the Fund is expected to make a return on the public capital with which it has been provided.

The key issue, to our mind, is that of incentives. An organization which uses public funds for a public purpose – such as providing support for PPP contracts – will inevitably have complex objectives and accountabilities. There are numerous reasons why the Government may want to support a particular PPP project, ranging from the more objective to the purely political. There can be no *a priori* rules, with regard to any individual project, which would govern how much risk the Government should take on. While the Government can protect itself by defining which risks it would cover, a Fund which enters into guarantee on behalf of the Government would inevitably have to live with ambiguities in its decisions with respect to individual projects. In other words, while a non-profit oriented Guarantee Fund can be held accountable for its overall financial sustainability (e.g. that its total assets provide adequate backing to its total liabilities), it will be difficult to monitor the quality of individual guarantee decisions.

This has a number of implications:

- **There will be a need to retain political control over the governance of the Fund.** The only way the Minister of Finance can be sure that the Fund will provide support to the projects which he/she would be happy to support would be by being on the Board, and by having the Board consist of other senior ministers and officials who can make high-level policy judgments about policy priorities.

- **The Fund’s main performance indicator will be whether its assets are sufficient to meet its expected liabilities.** The Government will need to approve the prudential rules, and then will monitor the Fund’s compliance with those rules. Initially, the Fund will start with a conservative 1:1 leverage ratio. Once the Fund establishes

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1 The leverage ratio typically refers to the ratio of assets to gross contracted liabilities. Assets must always equal the expected value of contingent liabilities. Since the expected value of a contingent liability is highly volatile, guarantee fund administrators tend to use rules of thumb for risk zones. Moreover, the value of the assets may also be uncertain if SOE shares are included. Hence, the actual leverage ratio may be quite volatile, and not entirely under the control of the Fund.
a track record, it might be able to leverage its assets. The rules for leveraging will need to be reviewed by the Government

- With respect to the guarantees, the staff of the Guarantee Fund will perform the project-specific advisory role which is currently performed by the RMU. Hence, there will be no need for RMU to advise on the project-specific guarantee issues, which will be covered by the Fund. The RMU will need to advise on leveraging rules for the Fund, and will assist the Minister of Finance in monitoring the Fund’s compliance with prudential requirements.

If the Fund is expected to make a return on the capital, the incentives and the accountabilities would more closely resemble standard commercial models. This approach would have the following implications:

- There would be arms-length separation between the function of assessing the risk of a PPP project, and the decision on whether to support that level of risk. The Fund would be able to apply clear and objective rules to assessing each project: it will need to make sure that the guarantee fee it quotes fully covers the risk associated with the project. The Government, separately will need to decide whether it wishes to pay the fee for that particular project, or if it can take steps to reduce risks and hence, reduce the guarantee fee

- In this context, any payment by the Government of the guarantee fee on behalf of the project will be treated as an explicit tariff subsidy (the alternative would be for the project developer to pay the fee, and to build it into the tariff). Hence, this approach will enable the Government to make better trade-offs between its support for various projects, and between public provision of infrastructure and provision through PPPs

- The Government will have clear commercial criteria for monitoring the performance of the Fund, and for holding the Board accountable. There will be no need for political involvement in the governance of the Fund. Hence, Board members can be selected for their commercial and transactional skills, rather than for their understanding of the Government’s policy objectives

- The Government will need to decide on whether it wishes to subsidize individual projects by paying the guarantee fee on their behalf. However, this will no longer be a risk management decision, but an explicit subsidy choice. Hence, it would make sense to locate those decisions not with the Risk Management Unit, but with the parts of the Ministry which assess subsidy/spending requests. The Fund will perform the risk assessment function currently allocated to the RMU.

The latter option provides for clearer incentives, and would reduce the risks of the Fund succumbing to political pressures and having to make compromises. However, a more commercial concept is also more complicated, and it will be harder to explain it politically. In particular, some may perceive the concept as the Government paying twice: first putting money into equity for the Fund, second, paying for the guarantees.

### 3.2.2 Relationship between the Fund and line Ministries

An additional consideration is how to incentivize contracting agencies, such as the Ministry of Transport, to prepare better projects, and to make better choices about which projects to
support. One option would be to require contracting agencies to pay guarantee fees out of their budgets. In this case, the spending ministry itself would have to make the choice about how to allocate limited funds, while the Ministry of Finance, in its annual negotiations with the spending ministry, would approve the overall budget allocation for the support of PPPs in the relevant sector.

Box 2 below provides an example of how spending agencies are incentivized in Colombia. While the concept of committing each agency to certain guarantee fee payments rather than uncertain contingent liabilities is different, the underlying logic of involving spending agencies in paying for the guarantee is similar.

**Box 2: Liabilities Management Fund in Colombia**

The legal framework in Colombia has since 1998 required budgeting for explicitly contracted contingent liabilities, and also provides policy guidelines on risk allocation to ensure that the use of guarantees reflects efficient risk transfer principles. Each Government entity providing a guarantee must include the estimated cost in its budget at the time a guarantee is granted, using valuation methodologies established by the Contingent Liabilities Division in the Ministry of Finance. Appropriations are based on a coverage of costs under 95 percent of possible outcomes for each guarantee. The entity pays the appropriated amount into a centralized *Contingent Liabilities Fund* (FCCEE) according to an agreed deposit plan. The deposit plan takes into account the cash flow of the entity and the risk profile of the guarantee, and attempts to smooth out deposits over time.

The law allows the use of temporary liquidity mechanisms to cover the appropriations to the FCCEE. FCCEE assets (which can only be invested in Government securities and AAA-rated instruments) are managed by a fiduciary. An estimate of contingent liabilities has begun to be reported annually to congress as part of the medium-term fiscal framework. Entities maintain a separate account with the FCCEE for each project, and for each type of risk within a project. The estimates of the expected value of each risk are reviewed annually by the Ministry of Finance to take into account new information, and the corresponding deposit plans are revised if necessary. If the guarantee is called, the FCCEE will cover only up to the amount in the respective account, the difference being met by the responsible entity. Money in an account cannot be transferred to cover the costs of calls arising from guarantees issued by other entities.

Once a specific risk has lapsed, the funds associated with that risk are transferred to other risk accounts within the same project; once the project is completed, funds are transferred to other projects undertaken by the same entity; and finally, if the entity has no other projects, funds are reimbursed to the entity.

Under such a model, the Guarantee Fund would help to:

- Manage the incentives faced by Government agencies
- Strengthen overall fiscal control. Procedures that require implementing agencies to “purchase” a guarantee from the Fund (by paying risk fees) convert an uncertain contingent liability for the budget into a predictable stream of fee payments
- Reduce cash flow risks to the Government
- Improve accountability and transparency of decisions.
Investors would benefit indirectly from this arrangement, since better management of inter-agency financial relations, and better overall control of contingent liabilities, would increase the credibility of the Government’s commitments to investors.

### 3.2.3 Possible Guarantee Fund Concepts

The table below summarizes possible Guarantee Fund concepts. We draw a distinction between an immediately feasible concept, and a possible long-term option, which would address a wider set of PPP issues, and towards which the Guarantee Fund could evolve over time. We would emphasize that:

- Important benefits can already be derived from the implementation of the more straight-forward immediate concept
- These benefits are not limited by the institutional limitations of the immediate concept. The Fund can change over time to address a wider set of PPP issues, and to improve further how those issues are addressed.

#### Table 3: Possible Guarantee Fund Concepts

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<tr>
<th></th>
<th>Immediate Concept</th>
<th>Possible Long-term Concept</th>
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<tbody>
<tr>
<td><strong>Fund operational objectives</strong></td>
<td>The Fund operates as an extension of the Ministry of Finance, and provides guarantees on behalf of the State. The operational objective is to ensure that an appropriate leverage ratio is implemented, and guarantees do not exceed the Fund’s ability to honor them. The Fund does not charge guarantee fees with respect to National PPP projects, but may charge fees for sub-national guarantees where the Government does not wish to support projects directly, but is happy to backstop them.</td>
<td>The Fund operates as a for-profit company, and charges guarantee fees for all projects. The operational objective is to achieve a target return on capital invested by the State (and, eventually, others) in the Fund. For National PPP projects, the Fund quotes guarantee fees to the Ministry of Finance, which then pays them on behalf of the State where the State wishes to provide such support. Sub-national entities, such as PLN, would pay the fee directly.</td>
</tr>
<tr>
<td><strong>Governance</strong></td>
<td>The Board consists of the Minister of Finance and other Ministers or senior officials. The Board approves each guarantee on the basis of public policy considerations.</td>
<td>Independent Board. The Board provides normal corporate governance, with appropriate approval delegations to the management</td>
</tr>
<tr>
<td><strong>Priorities</strong></td>
<td>The Government communicates to the Board its policy priorities, and the Board prioritizes the use of guarantee funds on the basis of these</td>
<td>The Fund develops guarantee products and sells them as appropriate. The rationing is on the basis of price. The Government, as shareholder,</td>
</tr>
<tr>
<td>Priorities</td>
<td>can influence the Board in its development of products</td>
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**Management operational objectives**
- Management provides project risk assessment and assessment of the Fund’s ability to support a project within its resources. Recommends decisions to the Board.
- Management undertakes project risk assessment, quotes appropriate guarantee fees, and, within delegation limits, approves guarantees while ensuring the matching of assets and liabilities. Management is responsible for the marketing of the Fund’s products.

**Management arrangements**
- Management contract with a private program manager. Performance objectives of the management contract based on the support the management needs to provide to enable the Board to make good public policy decisions.
- Management contract with a private program manager. Key performance objective in the management contract is to achieve the target return on equity and to maintain the sustainability of the Fund within the appropriate delegations. Some time in the future, the management contractor could be offered a small share of equity in the Fund, to strengthen performance incentives and entrench the independence of the Fund.

**Fund coverage**
- Limited risks for National PPP projects. As resources allow, eventually extend into support of sub-national entities.
- More freedom given to the Fund to find a market for itself. The Fund would have an incentive to look for possible deals and to identify needs, both at national and sub-national levels.

**Advantages**
- The Fund improves fiscal transparency and accountability, and allows better quality staff to be brought in through the management contract. The management contractor will have an incentive to protect its brand reputation by undertaking good quality analysis and presenting realistic recommendations to the Board.
- The Fund is more likely to be independent of political interference, and hence more likely to be financially sustainable. The Fund will have a single objective, and its performance will be relatively easy to monitor. The arms-lengths relationship between the Fund and the Ministry of Finance - where the Fund quotes a price on every guarantee which is requested by the Ministry, and the Ministry decides whether it
wishes to pay this amount - provides explicit and transparent information on the level of risk. This could strengthen the Ministry’s ability to argue not to provide support to poor quality projects or to improve projects in order to lower the price.

<table>
<thead>
<tr>
<th>Disadvantages</th>
<th>The Board may continue to face political pressures to prioritize poor quality projects – albeit the cost of such support and the risks will be more obvious. This Fund concept is not suited to providing guarantees for sub-national PPPs, which the Government does not wish to support directly.</th>
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<tr>
<td>Creating an arms-length commercial entity is a complex step, and will take time. The Fund will need to establish a track record before private investors would be interested. The Government may be less inclined to put resources into such a Fund than into a Fund it can directly control.</td>
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<tr>
<th>Funding</th>
<th>The Fund would primarily rely on annual injections of Budget allocation for the support of infrastructure PPPs. Annual Budget allocations will be needed to support operating costs. The Fund can also be capitalized through transfer of SOE shares and other State assets which could be sold in the event of a liability call.</th>
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<tr>
<td>The Fund’s revenue will depend primarily on guarantee fees (paid either by government or other guarantee beneficiaries). The initial capital injection will come from the Budget allocation and transfer of SOE shares and other assets. Profits will be re-invested, and Fund equity will be expected to grow. Further capital injections will come from future Budgets.</td>
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Source: Castalia

4 Guarantee Fund Options

There is a menu of institutional options that can be considered with respect to how a Guarantee Fund is set up and how it operates. Even though all of these options are consistent with the immediate Fund concept outlined above, each of them would respond differently to the objectives described above, and would have different levels of complexity with respect to their implementation.

Indonesian law allows for three main organizational options, which we describe below. We consider each option from the perspective of the immediate Guarantee Fund concept,
described above. However, it is also useful to consider the extent to which each legal entity would enable the Fund to evolve over time.

4.1 BUMN Persero

Guarantee Fund BUMN Persero would be a limited liability company in which the government would own 100 percent of the shares. The Persero will be capitalized with an equity injection from the Ministry of Finance—using a portion of the Rp 3 trillion that have been committed by the government for supporting PPPs, or any other amount that the Government is prepared to allocate for guaranteeing PPP projects (See box below).

This Persero would be in charge of:

- Reviewing requests for guarantees from other government agencies
- Deciding (below a certain threshold) or recommending to the Ministry how to decide on these requests
- Entering into guarantee contracts with private project companies or with government entities providing guarantees, and
- Making the necessary accounting provisions to prudently cover its exposure from guarantees.

The operational objective is this Persero is to cover its operating costs with the capital invested by the State, while fulfilling the above four functions. That is, the revenue of the Persero will be the yield of its capital invested—this revenue would be expected to cover all its operating costs.

**Box 3: How Can the Government Decide How Much Capital to Inject in the Fund?**

We think that there are at least two ways to think about how the Government decides how much money to allocate to the Guarantee Fund.

First, if the Government was committed to support all PPP projects that were deemed feasible, then the decision on how much money to set aside would be driven by the number of feasible projects in the pipeline, the expected contingent liabilities of these projects and the prudential rules with respect to making provisions to cover these liabilities. For example, if there are 10 projects in the pipeline for the next two years, the expected contingent liability on all these projects is Rp. 5 trillion, and prudential rules require Rp 1 of provisions for every Rp 2 of liabilities, then the fund would need an initial capital of Rp. 10 trillion.

Second, if the capital needed is greater than what the Government is prepared to assign to support PPP projects—which would most likely be the case in Indonesia—the decision on how much to allocate to the Guarantee Fund should be seen as a political decision no different than other budgetary allocation decisions. Because the demand for guarantees will be greater than the capacity of the Guarantee Fund to provide these guarantees, the decision on which projects to prioritize should in theory also be political—the Government would be best placed to decide how to allocate scarce budget resources to meet competing needs.

Source: Castalia

This Persero would have a Board of Directors (BoD) that will be appointed by the Ministry of State-Owned Enterprises (MoSoE), but Directors will be selected based on their
qualifications and be given the incentives to achieve the objectives of the Fund. The Board would provide normal corporate governance, with appropriate approval delegations to the management.

The Board would appoint a reputable financial institution as a Management Contractor—under a multi-year performance-based contract—to perform the day-to-day activities of the fund. The contractor would be selected through a competitive process and its remuneration will be partly based on its performance—including prudently managing the assets and liabilities of the fund, and covering its costs.

A BUMN Persero is created in three steps. First, approval from the President is required based on the recommendation of the Minister of State Owned Enterprises, and after consultation with relevant ministries. Second, a DPR issued Government Regulation is required—a petition to DPR should contain: corporate charter (constitution), list of Board members and rules for appointment/election, and statement of initial capital contribution. Third, after obtaining the Government Regulation, several steps defined in the Company Law would need to be completed to formally establish the Persero.

4.2 BUMN Perum

The Guarantee Fund BUMN Perum will be a state-owned enterprise which is wholly owned by the State, in the form of allocated State assets which are not divided into shares. The Perum would be tasked with achieving objectives similar to those for listed for the Persero.

Under this Perum, the Guarantee Fund would essentially operate as an extension of the Ministry of Finance, providing guarantees on behalf of the State. Its operational objective is to ensure that an appropriate leverage ratio is implemented, and guarantees do not exceed the Fund’s ability to honor them.

The Fund would rely on annual injections of Budget allocation for the support of infrastructure PPPs. Annual Budget allocations will be needed to support operating costs.

The Board consists of the Minister of Finance and other Ministers or senior officials. The Board approves each guarantee on the basis of public policy considerations. The Government communicates to the Board its policy priorities, and the Board prioritizes the use of guarantee funds on the basis of these priorities.

The Board would appoint a reputable financial institution as a Management Contractor—under a multi-year performance-based contract—to perform the day-to-day activities of the fund, and to recommends decisions to the Board. Performance objectives of the management contract based on the support the management needs to provide to enable the Board to make good public policy decisions.

A BUMN Perum is created in two steps. First, approval from the President is required based on the recommendation of the Minister of State Owned Enterprises, and after consultation with relevant ministries. Second, a DPR issued Government Regulation is required—a petition to DPR should contain: corporate charter (constitution), list of Board members and rules for appointment/election, statement of initial capital contribution, and articles of association.

4.3 BLU

The Guarantee Fund BLU will be established as a unit within the Ministry of Finance, and as such would be under the Ministry of Finance’s control. A BLU is not an independent legal
entity, and therefore all its assets and liabilities will be legally owned by the Ministry—that is, it is not a limited liability entity.

**Box 4: BLU**

The Badan Layanan Umum (BLU) is a relatively new institutional arrangement in Indonesia that allows the Ministry that created it some limited independence from the budget administration rules. The key limit on independence is the rule of having to return unused funds at the end of the fiscal year. For example, a BLU was established by the Ministry of Finance into which a Budget allocation for support of land acquisition, Infrastructure Investment Fund and the Guarantee Fund was parked. The unused funds allocated to this BLU will return to the Ministry of Finance at the end of the fiscal year, but the Ministry can reallocate these to the BLU for the following fiscal year.

The difference between a BLU and a government department is that a BLU can have a separate accounting system from the ministerial department it is under. BLU can have its own budget and can use its budget for its day to day operation independently. The status of BLU as an institution is granted by the Ministry of Finance.

A BLU has to submit a five year strategic business plan and an annual business plan to the ministerial department it is under. BLU’s annual business plan will then be included in the ministerial department’s yearly budget. To implement its annual budget, the BLU has to get approval from the ministerial department it is under.

BLU can receive budget allocation from the National Budget Plan (APBN) and can receive grants or loans from other sources such as multilateral and donors. These budget allocations will be treated as BLU’s revenue. Other sources of BLU revenue can come from fees charged for the services BLU provide.

The accounting system of BLU is an accruals basis accounting system (instead of cash-flow base), and should conform to the Standard Financial Accounting published by the Association of Professional Accountants.

Source: Castalia

A BLU based Guarantee Fund would operate as part of the Ministry of Finance. All legal documents related to the operation of the BLU (such as guarantee contracts) would be executed by the Minister of Finance. The functions of the BLU would be limited to:

- Reviewing requests for guarantees from other government agencies
- Recommending to the Ministry how to decide on these requests, and
- Making the allocations within its budget to prudently cover the exposure of the Ministry from guarantees granted.

Its operational objective will be to ensure that the guarantees issued by the Ministry do not exceed the Fund’s ability to honor them.

The Ministry of Finance would need to make annual budget allocations to cover the operating costs of the BLU, and to increase the funds that are available for backstopping guarantees.

The BLU would be governed directly by the Ministry of Finance, and not by a Board of Directors. The Minister would appoint a group of civil servants to perform the day-to-day activities of the BLU, and to recommend decisions to the Minister.
A BLU will be established through a ministerial decree from the Minister of Finance, upon satisfaction of the BLU Requirements set out in the Government Regulation No. 23 of 2005.

4.4 Other Options

Our review has revealed a number of other legal options. However, we do not discuss them in detail because they are either less practical or less suitable to the Guarantee Fund concept. The box below presents an example of another possible option.

**Box 5: Guarantee Corporation**

An alternative structure is for the Ministry of Finance to create an entity, similar to the existing Lembaga Penjamin Simpanan (LPS) (Deposit Insurance Corporation). LPS is a government corporation established by law. The law that created LPS defines the status of the entity, its functions and objectives. The law also defines who should be on the Board of Directors, and how the selection process should be undertaken. The Board reports directly to the President. LPS is a separate legal entity, and its assets are separate from the State assets, even if the initial funds are provided by the State. This type of structure could provide a more independent operation—however, it needs to be established through a law and this requires a lengthy and uncertain process.

Source: Castalia

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5 Comparison of Options

The matrix below presents our understanding of how each option responds to the objectives, and how complex it could be to implement each option.

**Table 4: Comparison of Institutional Options**

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Options</th>
<th>BUMN Persero</th>
<th>BUMN Perum</th>
<th>BLU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certainty</td>
<td></td>
<td>✔️ ✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Reduce PPP Costs</td>
<td>✔️ ✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Independence</td>
<td>✔️ ✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Provide incentives</td>
<td>✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Attract skills and experience</td>
<td>✔️ ✔️</td>
<td>✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Ease of Implementation</td>
<td>✔️</td>
<td>✔️ ✔️ ✔️</td>
<td>✔️ ✔️ ✔️</td>
<td></td>
</tr>
<tr>
<td>Opportunities for Evolution</td>
<td>✔️ ✔️ ✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
</tbody>
</table>

Source: Castalia

This simple comparison of the options, although difficult to make objectively, provides information that can be useful for the Government in selecting the most appropriate institutional option for the Guarantee Fund.
Overall, the Persero structure appears to provide a better alternative when compared to the Perum and BLU structures. Below we explain why we think the Persero structure is a better alternative.

**Greater certainty**
Shifting PPP liabilities to a separate Persero entity with limited liability would reduce risks to the Government accounts. The Government’s exposure is limited by its equity in the Persero. Under a BLU structure, the liabilities would extend to the Ministry of Finance. While Perum is also a limited liability entity, its separation from the Ministry of Finance would be less complete.

**Independence**
There is an expectation that Persero entities will be run on the basis of commercial objectives, while both Perum and BLU are seen as direct extensions of the machinery of government. Hence, it would be easier to ensure that this structure is operated with greater independence.

**Attract Necessary Skill**
The Persero structure, in contrast with the Perum and BLU, would be able to pay more, and hence attract staff with necessary skills. Also, through the management contract with a reputable financial institution, all three structures can improve staff performance incentives.

**Incentives**
In principle, the incentives under all three structures would depend on the charter of the entity, and on the terms of the management contract. However, given that Persero is expected to operate commercially, it would more naturally support a better incentive structure than a BLU or Perum.

**Ease of Implementation**
Because the Persero and Perum structures require Government Regulation to be established, they will take longer to be implemented than a BLU structure. Furthermore, it is possible that the DPR review process of the draft Government Regulation would result in changes to the structure that can undermine the desired independence of these structures. There does not appear to be any additional difficulty in setting up a Persero compared to a Perum.

6 **Example**
This section presents an example of how the Guarantee Fund Persero would work for a toll road project—if adopted as described above. The figure below illustrates the institutional and contractual structure for the guarantee.
6.1 Creation of Guarantee Fund Persero

The fund will be established following the required legal procedures, including approval from the President and the issuance of a Government Regulation. The Government Regulation will define the objectives of the Persero as described in section 4.1, and will define the principles that should be followed with respect to:

- Defining the minimum qualifications and experience of the Directors, the procedure for appointing these Directors, and the performance criteria and remuneration for these Directors
- Selecting, engaging, monitoring and remunerating the management contractor
- Making decisions on offering guarantees, and defining the terms of these guarantees
- Making prudential provisions to the exposure from the guarantees, and
- Managing the funds in the accounts of the Fund

The initial capitalization of the fund would be calculated based on the pipeline of PPP projects that will require support for the next two to three years, and the principles defined for prudential management of the Fund.

The capital for the Fund would come from cash or assets transferred by the Ministry of Finance, and possibly from loans—current or contingent—from a multilateral agency like the World Bank.
6.2 Guarantee Request and Approval Process

This example refers to a toll road project that the Ministry of Transport wants to develop under a concession contract with a private firm. To comply with the requirements established in Perpres 67 and PMK 38, the Ministry of Transport would first carry out the demand and feasibility study for the project, analyze the type and level of government support needed, and submit a request to KKPPI. Having reviewed the request and determined that the project is feasible, KKPPI will forward this request to the Ministry of Finance—which in turn would forward it to the firm retained as management contractor by the Guarantee Fund Persero.

The staff of the Persero (they could also be staff of the management contractor firm) will review the request, including carrying out an independent valuation of the expected present value of the occurrence of the risk event that will be covered by the Guarantee. This will include developing a financial model that is capable of running stochastic simulations of risk variables. If the independent valuation is different than the valuation of the Ministry of Transport, representatives of both parties will attempt to identify and reconcile the differences.

Having defined the value of the contingent liability, the Fund will make a decision on the terms of the guarantee that will be offered—or on not offering a guarantee at all. For projects below a certain threshold, the decision will be made by the management contractor; and for projects above this threshold, the decision would be made by the Board of the Fund.

For example for a toll road, the Fund may decide to offer a ridership guarantee that would be called if traffic fell below a certain level, but that will also require the project sponsor to share the gains with the Ministry of Transport or the Fund when demand exceeds a certain level. The guarantee would pay the project sponsor 80 percent of the toll multiplied by the difference between the minimum traffic and the actual traffic.

7 Next Steps

This note presents our understanding of the objectives that the Government could seek to achieve with the creation of the Guarantee Fund, as well as a set of institutional options to establish the Guarantee Fund. The note also identifies a BUMN Persero type entity as one institutional option that could, in comparison to a BUMN or BLU, be most responsive in terms of achieving the objectives identified. Establishing a Persero however, would require the issuance a Government Regulation to this effect, which could create the risk of significant delays or that the desired governance and management features are altered to diminish the desired independence of the Fund.

As the first step, the Government needs to decide if it agrees with the Guarantee Fund objectives identified in this note. If it does, the Government needs to decide if it agrees with the options, and the analysis of those options presented in this note. Having decided on the option, the next step would be to design this option in detail, and to prepare the necessary documentation to formally initiate the process for implementing it.

Should the Government decide to pursue the idea of establishing a Persero, the steps and timing associated with implementing this entity will be as presented in Table 5. Once the Government chooses to proceed, it can run discussions with the World Bank about the
backstop facility and other forms of support concurrently with the organizational steps set out below.

**Table 5: Steps to Implement a Guarantee Fund Persero**

<table>
<thead>
<tr>
<th>Tasks</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Draft concept note with key features – reach consensus with MoSoE and other relevant ministries</td>
<td>2 to 3 months</td>
</tr>
<tr>
<td>Draft Government Regulation and detailed supporting documents, including Articles of Association, and Management Contract</td>
<td>3 to 4 months</td>
</tr>
<tr>
<td>Obtain initial authorization from the President</td>
<td>2 to 3 months</td>
</tr>
<tr>
<td>Obtain approval from DPR and issuance of Government Regulation</td>
<td>Unknown</td>
</tr>
<tr>
<td>Obtain deed of establishment as well as other tax or legal authorizations required by the company law</td>
<td>2 to 3 months</td>
</tr>
<tr>
<td>Select and appoint Directors and Management Contractor</td>
<td>3 to 4 months</td>
</tr>
</tbody>
</table>

Source: Castalia