Document of

The World Bank
and
International Finance Corporation

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Report No: 48639-ID

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$100 MILLION

TO THE

REPUBLIC OF INDONESIA

AND A PROPOSED

INTERNATIONAL FINANCE CORPORATION

EQUITY INVESTMENT OF UP TO US$40 MILLION

IN THE

INDONESIA INFRASTRUCTURE FINANCE FACILITY

IN THE REPUBLIC OF INDONESIA

June 2, 2009

Poverty Reduction & Economic Management/
Finance & Private Sector Development Department
Indonesia Country Unit
East Asia & the Pacific Region
The World Bank

Infrastructure Department &
Global Financial Markets Department
East Asia Region
International Finance Corporation

REPUBLIC OF INDONESIA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of May 27, 2009)

Currency Unit = Rupiah (Rp)
Rp 10,320 = US$1

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Co-Team Leader:	Denis Clarke	Senior Investment Officer:	Matthias Hedinger

The Indonesia Infrastructure Finance Facility Loan and Equity Investment is a collaborative Bank Group effort. The Bank's loan is being prepared by a team supervised and task managed by P. S. Srinivas (EASFP), and consisting of Jeffrey John Delmon (FEU), The Fei Ming (EASFP), Djauhari Sitorus (EASFP), Neni Lestari (EASFP), Tim Bulman (EASPR), Shubham Chaudhuri (EASPR), Rajat Narula (EAPCO), Unggul Suprayitno (EAPCO), Yogana Prasta (EACIF), Imad Saleh (EAPCO), Amien Sunaryadi (EACIF), Indira Dharmapatni (EASIS), Andrew Daniel Sembel (EASIS), Melinda Good (LEGES), Jose Zevallos (EAPCO), Andri Wibisono (EASIS), and Shienny Lie (EACIF). The IFC equity investment is being co-led by Denis Clarke (CINUT) and Arun Sharma (CGFTG) and includes Mathias Hedinger (CGFP6), Marina Feldman (CLEFM), Robin Sandenburgh (CESI2), and Yoshiko Saito (GCMSM).

The joint Bank-IFC team has also worked closely with a number of colleagues from other institutions: V. Subramanian, Adiwarman Idris, Howard Brooke, and Noraya Soewarno (ADB); Manfred Kiefer and Dirk Steinwald (KfW); Hans-Jurgen Hertel, Stephan Blanke, and Rena Haynes(DEG); Peter Dirou, David Hawes, Andrew Dollimore and Robin Taylor (AusAID).

The World Bank team is working under the overall guidance of Vikram Nehru (Sector Director), Tunc Uyanik (Sector Manager) and Joachim von Amsberg (Country Director, EACIF). The IFC team is guided by Georgina Baker, Director CGF, Adam Sack, Country Manager, Indonesia, and the management teams of both the Infrastructure and Financial Markets departments.

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	ILFS	Private Infrastructure Financing Facility
APBN	National Expenditure Budget	IL&FS	Infrastructure, Leasing & Financial Services
AMDAL	Environmental Impact Assessment	IMF	International Monetary Fund
ASKI	Indonesian Financial System Architecture	IPDP	Indigenous People Development Plan
AUM	Asset Under Management	IPO	Initial Public Offering
AusAID	Australian Agency for International Development	IRM	Investment Review Meeting
BAPPENAS	National Development Planning Agency	Jamsostek	Jaminan Sosial Tenaga Kerja (Employee Social Security)
Bapepam-LK	Indonesian Capital Market and Financial Institution Supervisory Agency	JIBOR	Jakarta Interbank Offered Rate
BAPINDO	Bank Pembangunan Indonesia	KfW	Kreditanstalt fur Wiederaufbau
BBD	Bank Bumi Daya	KIK	Kredit Investasi Kecil (Small Investment Loan)
BCA	Bank Central Asia	KKPPI	National Committee for the Acceleration of Infrastructure Development
BD	Business Development	KUPEDES	General Rural Credit
BDN	Bank Dagang Negara	KUR	People's Business Credit
BI	Bank Indonesia	KWh	Kilo-watt per hour
BII	Bank International Indonesia	LARAP	Land Acquisition & Resettlement Action Plan
BNI	Bank Negara Indonesia	LDR	Loan Deposit Ratio
BPJT	Indonesian Toll Road Authority	LoC	Line of Credit
BPN	National Land Agency	LPS	Deposit Insurance Corporation
BPPSPAM	Water Sector Advisory Body	MIC	Middle-Income Country
BRI	Bank Rakyat Indonesia	MIT	Massachusetts Institute of Technology
CAR	Capital Adequacy Ratio	MOPW	Ministry of Public Works
CAS	Country Assistance Strategy	MoU	Memorandum of Understanding
CEO	Chief Executive Officer	Mw	Megawatt
CFO	Chief Financial Officers	NAV	Net Asset Value
CMEA	Coordinating Ministry for Economic Affairs	NBFI	Non-Bank Financial Institution
CoI	Conflict of Interest	NIM	Net Interest Margin
CPS	Country Partnership Strategy	NPA	Non Performing Assets
CRISIL	Credit Rating & Information Systems of India Ltd.	NPL	Non Performing Loan
DA	Designated Account	OM	Operations Manual
DEG	Deutsche Investitions und Entwicklungsgesellschaft	PDAM	Public Water Utilities
DGH	Directorate General of Highways	PEMDA	Local Government Entity
DJLK	Directorate General of Financial Institution	Perpres	Presidential Regulation
DIPA	Budget Activity Lists	PKSK	Financial Sector Policy Package
DPL	Development Policy Loan	PLN	State Electricity Company
DPL-DDO	Development Policy Loan – Deferred Drawdown Option	PPI	Private Participation in Infrastructure
EPF	Employer Pension Funds	PPP	Public-Private Partnership
E & S	Environment & Social	PSO	Public Service Obligations

ESMS	Environment & Social Management System	QAG	Quality Assurance Group
ESW	Economic and Sector Work	RDB	Regional Development Bank
FEC	Fond d'Equipment Communal	RoA	Return on Assets
FIL	Financial Intermediary Loan	RoE	Return on Equity
FIPF	Financial Institution Pension Fund	RPJM	Government's Medium-Term Development Plan
FSAP	Financial Sector Assessment Program	SBI	Central Bank Policy Interest Rate
FSSF	Financial System Stability Forum	SMI	P.T. Sarana Multi Infrastructure
GDP	Gross Domestic Product	SMIE	Small Medium Industrial Entreprises
GOI	Government of Indonesia	SME	Small Medium Entreprises
GWM	Minimum Reserve Requirement	SMF	Sarana Multigriya Financing
IBRD	International Bank for Reconstruction and Development	SOB	State Owned Bank
IC	Investment Climate	SOE	State Owned Enterprise
IDFC	Infrastructure Development Finance Company	SoE	Statement of Expenditure
IDR	Indonesian Rupiah	SPM	Payment Order
IDPL	Infrastructure Development Policy Loan	SPV	Special Purpose Vehicle
IDX	Indonesian Stock Exchange	TA	Technical Assistance
IEG	Independent Evaluation Group	ULB	Urban Local Business
IFC	International Finance Corporation	US$	United States Dollar
IFI	International Financial Investment	YoY	Year on Year
IG	Inspector General	YTD	Year to Date
IHSG	Jakarta Composite Index		
IIFF	Indonesia Infrastructure Finance Facility		

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INDONESIA INFRASTRUCTURE FINANCE FACILITY

PROJECT APPRAISAL DOCUMENT

EAST ASIA AND PACIFIC

EASFP

Date: May 28, 2009 Country Director: Joachim von Amsberg Sector Manager/Director: Tunc Tahsin Uyanik /Vikram Nehru Project ID: P092218 Lending Instrument: Financial Intermediary Loan	Team Leader: Subrahmanya Pulle Srinivas Sectors: General finance sector (100%) Themes: Other financial and private sector development (100%) Environmental screening category: Financial Intermediary Assessment

Project Financing Data

[X] Loan [ ] Credit [ ] Grant [ ] Guarantee [X] Other: Equity

For Loans/Credits/Others:
Total Bank financing (US$m.): 100.00
Proposed terms: Variable Spread Loans, standard terms for 24.5 years including 9 years grace.

Financing Plan (US$m)

Source	Local	Foreign	Total
Borrower	0.00	0.00	0.00
International Bank for Reconstruction and Development	0.00	100.00	100.00
Total:	0.00	100.00	100.00

Borrower:
Republic of Indonesia
Indonesia

Responsible Agency:
Director General of State Assets
Ministry of Finance
Government of Indonesia
Indonesia
Ministry of Finance
Jl. Lapangan Banteng 2-4
Indonesia
Tel: (62-21) 251-2222Fax: (62-21) 572-2446
suyatno_harun@yahoo.com
Director, Directorate General of Asset Management
Ministry of Finance

Indonesia
Tel: (62-21) 385-2143Fax: (62-21) 384-4784

Estimated disbursements (Bank FY/US$m)									
FY	2010	2011	2012	2013					
Annual	10.00	48.00	40.00	2.00					
Cumulative	10.00	58.00	98.00	100.00					

Project implementation period: Start July 2009 End: June 2013
Expected effectiveness date: July 31, 2009
Expected closing date: December 31, 2013

Does the project depart from the CAS in content or other significant respects? ***Ref. PAD I.C.***	[ ]Yes [X] No
Does the project require any exceptions from Bank policies? ***Ref. PAD IV.G.***	[ ]Yes [X] No
Have these been approved by Bank management?	[ ]Yes [X] No
Is approval for any policy exception sought from the Board?	[ ]Yes [X] No
Does the project include any critical risks rated "substantial" or "high"? ***Ref. PAD III.E.***	[X]Yes [ ] No
Does the project meet the Regional criteria for readiness for implementation? ***Ref. PAD IV.G.***	[X]Yes [ ] No

Project development objective ***Ref. PAD II.C., Technical Annex 3***

The objective of the Project is to strengthen and further develop the institutional framework of the financial sector to facilitate financing of commercially viable infrastructure projects and thereby increase provision of private infrastructure in Indonesia.

Key performance indicators to judge IIFF#s success include the following outcomes: (i) increase in the number of commercially viable infrastructure projects achieving financial closure through long-term debt financing, other financial products, and advisory services from the IIFF over the life of the project; (ii) Increase in the amount of private capital (including long-term debt and equity) available for infrastructure projects over the life of the project; (iii) Increased support to government's policy making in private provision of infrastructure through advisory services from IIFF; and (iv) Increase in privately financed infrastructure in Indonesia. Quantitative targets for these indicators have been incorporated in the results matrix attached to the PAD.

Project description *[one-sentence summary of each component]* ***Ref. PAD II.D., Technical Annex 4***

The IIFF will provide predominantly long-term loans, guarantees, equity investments and other financial products as well as advisory services to commercially viable infrastructure projects. The Bank will provide an investment loan to the Republic of Indonesia as the Borrower. The Borrower will in turn provide these funds to the IIFF - the sole participating financial intermediary - through SMI (a vehicle established by the Government to channel its equity investments and loans to the IIFF). These funds will provide the basis for long-term finance and other financial products offered by the IIFF. The ADB is also providing a loan to the Republic of Indonesia for the same purpose. In addition, IFC, DEG, and ADB are also taking equity stakes in the IIFF. The IIFF will leverage its initial capital base to mobilize capital from domestic and

international sources.
Which safeguard policies are triggered, if any? ***Ref. PAD IV.F., Technical Annex 10*** IIFF complies with OP 8.30 for financial intermediary (FI) lending. The environmental assessment category of the Project is "FI". The Bank's safeguard policies that may be triggered by subprojects that IIFF is likely to finance include OP 4.01 (Environmental Assessment), OP 4.04 (Natural Habitats), OP 4.11 (Physical Cultural Resources), OP 4.12 (Involuntary Resettlement), OP 4.10 (Indigenous Peoples), OP 4.36 (Forestry), and OP. 37 (Safety of Dams). As IIFF will not finance irrigation or agriculture projects, OP 4.09 (Pest Management) is not triggered. As an FI operation, an environmental and social safeguards framework (ESSF) and management system (ESMS) approach is being followed to comply with applicable WBG Policies and IFC Performance Standards on Environmental Social Sustainability (IFC PS).
Significant, non-standard conditions, **if any**, for: ***Ref. PAD III.F.*** Board presentation: None. Loan/credit effectiveness: July 2009. Covenants applicable to project implementation: It is important to highlight that IIFF can only be established after approvals of equity investments and loans of the Bank/IFC and other IFIs involved have been obtained. In this situation, as is normal for project financing which relies on simultaneous conditions precedent being met across various sources of loan and equity financing, it is clear that there will be a set of effectiveness conditions prior to disbursement of the Bank's loan. The World Bank will enter into a Loan Agreement with the Republic of Indonesia and a Project Agreement with SMI and IIFF. The following are expected to be Conditions of Effectiveness: • the Subsidiary Loan Agreement, acceptable to the Bank, shall have been duly executed and delivered on behalf of the Borrower and SMI and shall have become effective and binding upon such parties in accordance with their respective terms, subject only to the effectiveness of the Loan Agreement; • the Subordinated Loan Agreement acceptable to the Bank, shall have been duly executed and delivered by or on behalf of SMI and the IIFF and shall have become effective and binding upon such parties in accordance with their respective terms, subject only to the effectiveness of this Loan Agreement; • the IIFF shall have been legally incorporated pursuant to the Borrower's laws and regulations and the Articles of Association of the IIFF shall have been executed by the founding Shareholders and approved by MLHR. • the Borrower, through the MOF, shall have issued the Business License to the IIFF; • the Co-financing Agreement (ADB Loan Agreement) shall have been executed and delivered and all conditions precedent to its effectiveness or to the right of the Borrower to make withdrawals under it (other than the effectiveness of this Agreement) have been fulfilled;

- the Shareholders Agreement, and any related share subscription documents to be entered into by and among the founding Shareholders and/or between the IIFF and the founding Shareholders shall have been executed and delivered on behalf of the parties and shall have become effective and binding upon such parties in accordance with their respective terms;
- the Project Agreement, shall have been duly executed and delivered on behalf of SMI and the IIFF and shall have become effective and binding upon the SMI and the IIFF in accordance with their respective terms;
- the Operations Manual, including the ESSF, acceptable to the Borrower and the Bank, shall have been adopted by the IIFF;
- each founding Shareholder shall have subscribed and paid up its respective initial capital contribution in such amount as required by the Shareholders Agreement;
- SMI shall have made available and disbursed financing in an amount of not less than IDR 600 billion (equivalent to about USD60 million) (less the amount of the initial equity contribution of SMI as required under the Shareholders Agreement); and
- the IIFF shall have appointed and employed a chief executive officer, a chief financial officer and an environment and social safeguards staff acceptable to the Borrower and the Bank.

In addition to standard terms and conditions, the Loan Agreement and Project Agreement will contain the following covenants:

- Except as the Bank and the Borrower shall otherwise agree, the Borrower shall ensure that the IIFF shall not incur any subordinated debt (referring to the loans from the Bank and ADB), if after the incurrence of such subordinated debt the ratio of subordinated debt to equity shall be greater than 2.5 to 1.
- Additional suspension events include the failure of any of GoI, SMI or IIFF to perform their obligations under the Subsidiary Loan Agreement, the Subordinated Loan Agreement or the Shareholders Agreement; the failure if IIFF to maintain its business license, the amendment, suspension, abrogation, repeal or waiver of any of the GoI regulations that allow the establishment and operation of IIFF, the Subsidiary Loan Agreement, the Subordinated Loan Agreement, the Shareholders Agreement, the Articles of Association, the Business License or the Operations Manual so as to affect materially and adversely the carrying out of the Project.

I. STRATEGIC CONTEXT AND RATIONALE

1. **The proposed project aims to support the Government's efforts to establish a non-bank financial institution** – the Indonesia Infrastructure Finance Facility (IIFF) - that will assist in the development of, and provide long-term local currency financing to commercially-viable infrastructure projects. The IIFF will support the efforts of the Government of Indonesia to improve the enabling and regulatory environment for infrastructure projects, especially those structured as public-private partnerships. It is anticipated that this will help increase the number of infrastructure projects that can be financed primarily with private sector resources. Initially, the new institution will be owned by the Government of Indonesia (as a minority investor) and a group of International Financial Institutions (IFIs), but the expectation is that they will be joined as shareholders by at least two commercial banks (probably one international and one domestic) within its first year. It will be managed on a commercial basis to provide a return to its shareholders by financing sound, well-financed private infrastructure ventures[1]. The IIFF will be established after Board approval and its staffing and final operations manual will be put in place prior to project effectiveness.

2. **The IIFF is an integral part of a comprehensive Government strategy to accelerate investment in infrastructure as Indonesia further establishes and enhances its middle-income country (MIC) status.** The Government has requested the Bank Group to support its efforts in establishing the IIFF as part of its own development priorities and poverty-reduction agenda through the release of a key constraint on the country's economy growth – inadequate infrastructure. This innovative Bank Group initiative has featured the participation of both the Bank and the IFC throughout the preparation process, and is expected to result in both institutions providing financial support to the IIFF. This may provide a model for future joint Bank/IFC support to important Government initiatives in Indonesia.

3. **This financial sector initiative complements several sectoral and macroeconomic initiatives aimed at accelerating infrastructure development in Indonesia.** It grows out of sustained efforts by the Government and the Bank to return infrastructure investment to the required levels since Indonesia began to recover from the Asian financial crisis in the early years of this decade. This section provides brief descriptions of and interplay between the broad country context, the infrastructure sector context, the financial sector context, providing the rationale for setting up such a new institution[2].

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[1] IIFF is modeled on similar institutions elsewhere, notably the Infrastructure Development Finance Corporation in India (in which IFC was an early investor) which succeeded in raising the quality of infrastructure investment and the confidence of domestic lenders in supporting it.

[2] Detailed discussions of the overall reform agenda in Indonesia are available in the recent Country Partnership Strategy (Indonesia: Country Partnership Strategy FY09-12 (Report No. 44845-IND), 2008), Fifth Development Policy Loan (Indonesia: Fifth Development Policy Loan (DPL 5) (Report No. 46332-ID), 2008), and Public Expenditure Support Facility (DPL-DDO) (Indonesia: Public Expenditure Support Facility (PESF) Development Policy Loan with Deferred Drawdown Option (DPL-DDO) (Report No. 47280-ID), 2009). Detailed discussions of the overall infrastructure sector issues are available in the Second Infrastructure Development Policy Loan (Indonesia: Second Infrastructure Development Policy Loan (Report No. 46328-ID), 2008) documents.

A. Country and Sector Issues

Country Context

4. **Indonesia's economy has rebounded from the 1998/99 crisis.** Supported by sound policies and a favorable external environment, output has grown strongly, inflation has been reduced, and international reserves continue to be close to all time highs. The government, banking, and corporate sectors have reduced balance sheet vulnerabilities. Indonesia's economy grew 6.3% in 2007 and 6.1% in 2008 despite the impact of the global slowdown in the second half of 2008. High commodity prices and the rapid growth of coal and palm oil exports have played their roles, but strong domestic investment and consumer demand have also been drivers of growth. Indonesia has had a primary budget surplus in each of the last three years and has maintained its overall budget deficit at low levels – 1.3 % of GDP in 2007 and a near balanced budget in 2008. Indonesia's debt-to-GDP ratio has declined significantly from 55 % in 2004 to 33 % in 2008. The country entered the ongoing global financial crisis in a relatively strong position. Annex 1 provides further details of recent economic developments.

5. **Indonesia's economic improvement has been recognized by the rating agencies.** In February 2008, Fitch upgraded the country's sovereign rating from 'BB-' to 'BB', two notches below the Investment Grade for foreign and domestic currency debt, praising Indonesia's aggressive structural reforms. In October 2007, Moody's upgraded Indonesia's ratings to reflect the country's track record of fiscal prudence and improvements in its external position, as well as ongoing structural reforms and sound policy management. The government's foreign- and local-currency bond ratings were upgraded by one notch to Ba3 from B1, while Indonesia's foreign-currency bond ceiling was upgraded to Ba2 from Ba3. Moody's also upgraded the country ceiling for foreign-currency bank deposits, from B2 to B1. This positive trend was reflected in a substantial reduction in IFC's country spread for Indonesia earlier this year.

6. **Recent turmoil in financial markets has affected Indonesia.** Because of its relatively open capital account, the significant foreign presence in Indonesia's stock and bond markets and the legacy of the 1997/98 crisis (which has left Indonesian investors sensitive to exchange rate movements and prone to capital flight), Indonesia was hit hard last October and November. The Government has taken a series of steps including arranging a US$5.5 billion contingent facility with the World Bank, the ADB, Japan, and Australia. The 2009 budget, approved in November 2008, expands the planned deficit from 1 % of GDP to 2.5 %. These measures appear to have restored stability to financial markets and prospects of renewed growth. The Bank expects growth to slow to 3.4% in 2009, before gradually recovering to the 5% range in 2010. Indonesia is expected to weather the global slowdown relatively well.

Political Considerations

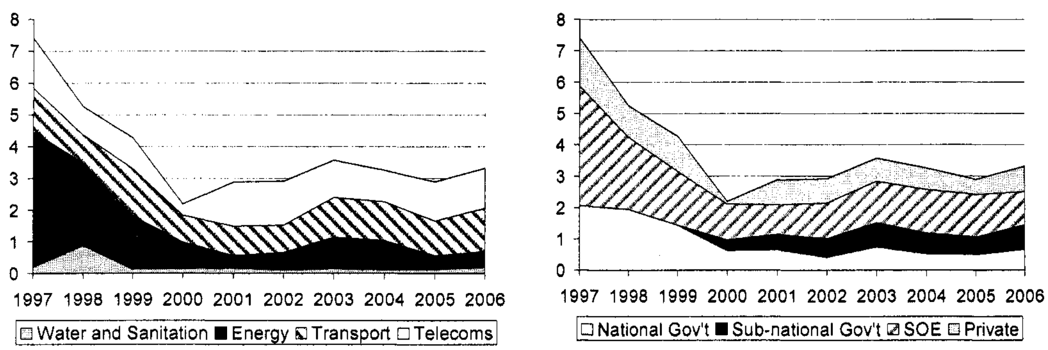
7. **Susilo Bambang Yudhoyono became the first directly elected President of Indonesia in 2004.** His party has received just over 20% of the vote in parliamentary elections in April 2009 making it the single largest party in the new parliament. Polls currently show that the incumbent in the lead in Presidential elections in July (or September, should a run-off election be necessary). The consolidation of democracy and the re-election of a reformist government in sufficient strength to press forward with its reform mandate over a new term, is encouraging. During its current term, the Government has demonstrated a willingness to make difficult decisions to ensure sound governance in the financial sector. Actions included the investigation and conviction on corruption charges of senior executives of state-owned enterprises. This focus on sound governance is in line with the Government's desire for the IIFF to have operational independence.

Infrastructure Sector Context[3]

8. **Indonesia has among the lowest levels of access to infrastructure investment in the region.** Following the 1997/98 financial crisis, infrastructure investment fell from over 7% of GDP to just over 2% in 2001 (see Figure 1). Since then, infrastructure investment has risen to over 3% of GDP, insufficient to meet the growing demand from existing infrastructure users, or to address the needs of the large parts of the population who do not have access to basic infrastructure services. The decline in investment was particularly dramatic in the energy sector, resulting in widespread blackouts and load shedding. Investment in water and sanitation has long been insufficient to expand access to piped water or to begin developing adequate sewerage systems. Transport investment has held relatively steady as a proportion of GDP, but realizing the potential benefits of an expanded highways network and urban mass transport systems is likely to require significant additional resources beyond current investment levels. Inadequate infrastructure is now widely seen as a key constraint to sustained economic growth and poverty reduction in Indonesia. The Government's infrastructure program addresses several challenges facing public and private infrastructure investment, and the Bank has supported progress in the most significant elements of the Government's reform program through its IDPL series. Further details of the Government's infrastructure development program are available in Annex 2.

9. **While public spending on infrastructure has increased since 2000, private sector interest has yet to return.** The Government is drafting its 2010-2014 five-year plan, during which it estimates it will require infrastructure investments worth roughly 5 % of GDP – approx. IDR1800 trillion or US$170 billion. Given limited fiscal space, encouraging substantial private sector investment in infrastructure is one of the Government's highest priorities. It aims to secure IDR365 trillion or US$33 billion worth of private infrastructure investments[4] over the next five years. However, past attempts have consistently fallen far short of expectations. Significant progress must be made on several fronts to mobilize private sector investment, including the creation of good infrastructure sector policies, well-designed projects and concession contracts, and a transparent investor selection process. The capacity of the financial sector to provide the long-term local currency financing without which such projects cannot offer competitively-priced infrastructure services must also be developed. The proposed project is at the heart of a suite of new initiatives to address these constraints.

Figure 1: Investment in Infrastructure
(% of GDP)



Sources: Indonesian Government statistics for national and sub-national governments; Annual reports for state-owned enterprises, with data for PT Telkom in 1997 and 1998 interpolated from the data for 1996 and 1999; World Bank's PPI database for private investment, excluding cancelled projects.

[3] For more details, see Indonesia: Second Infrastructure Development Policy Loan (Report No. 46328-ID), 2008.

[4] Presentation by Bappenas on February 10, 2009.

10. **The Government is pursuing PPP transactions in all infrastructure sectors, including toll-roads, power plants, natural gas pipelines, railways, ports, bulk water plants, airports, and telecommunications projects.** Modest results are beginning to show. Some short sections of toll-roads and small bulk water treatment plants have begun operation. Construction has commenced on over US$2 billion worth of new PPP projects, including power plants, toll-roads, and water treatment plants. Slow progress has generally been the result of poor project preparation and inadequate background analysis prior to tendering, resulting in unrealistic expectations by tendering agencies. Over the past year the Government has strengthened the project preparation process and placed greater emphasis on the use of qualified external advisers. For example, an electrical plant in Central Java is being prepared with the assistance of an IFC advisory mandate. The ADB has mobilized a PPP project development facility funded by a US$26.5 million loan and a US$7.5 million grant provided by the Netherlands. The facility supports 20 national and sub-national PPP projects, including toll-roads, ferry terminals, bulk water supply systems, railways, an airport, and a telecommunications project. Current support emphasizes improving the quality of feasibility studies prior to bidding. The Bank is undertaking a review of the PPP program, to identify areas for additional technical assistance.

11. **The Ministry of Finance currently only authorizes guarantees or direct financial support for PPPs that comply with Perpres 67.** This requires three bids from a competitive tendering process, and does not allow for the "Competitive Dialogue" process that is used to develop PPPs in most countries successfully applying this model. Given the infancy of Indonesia's PPP program, the inability to develop projects through a dialogue with those investors capable and potentially interested in delivering the services has proven a practical barrier. Revisions to Perpres 67 are being considered that would authorize negotiations with bidders in cases where fewer than three bids are received. This would open the way for the provision of Government support to a wider range of transactions and increase the number of bankable projects.

12. **The Government is also taking measures to address land acquisition issues that have blocked private toll-road development.** The Ministry of Public Works established a revolving land fund in January 2007. The fund finances land acquisitions for toll-roads, and is reimbursed by the concessionaire when land acquisition is completed. The fund has been accessed by eight toll-road concessionaires, of which six have now commenced construction: one toll-road section is already operational.

13. **Fourteen toll-road concession contracts awarded prior to the financial crisis in 1997/98 have not moved to financial close in part because of an escalation in the cost of land acquisitions.** The Government has developed a "land-capping" scheme, under which the concessionaires will pay 110% of the land costs initially envisaged, with the Government to pay for the remaining land acquisition costs. The Government funds available for this scheme are capped at IDR4.9 trillion. The Government intends to terminate transactions that do not move to financial close after accessing the land-capping funds.

14. **In addition to the IIFF, the Government is also developing other institutions to support infrastructure financing.** A Guarantee Fund is being prepared to ensure the availability of government money to honor guarantees made to private infrastructure projects. The amount of money available in the fund will cap the level of contingent liabilities the Government may assume. The Bank is providing technical assistance in the development of the Guarantee Fund.

15. **The IIFF aims to draw many of these initiatives together and apply focused policy advice, project finance expertise,** commercial-drive and the advantages of access to attractive long-term finance to raise private investment in infrastructure over the next five years to several times its current levels.

Financial Sector Context

16. **Banking continues to be the largest subsector in the Indonesian financial sector, representing about 80% of all financial assets** (about IDR2942 trillion, 59.4% of GDP) in 2008. Bank Indonesia data for February 2009 indicates the banking sector's financial performance remains sound, despite ongoing volatility in global financial markets and its adverse impacts on Indonesia. The gross Non-Performing Loan (NPL) ratio at the end of February 2009 was 3.7%, up from 3.2% in December 2008. The banking sector's Capital Adequacy Ratio (CAR) was 18.1% as of February 2009. Profitability as measured by the ratios of annual return on assets (ROA), return on equity (ROE), and net interest margin (NIM) are quite high, at 2.6%, 10.5% and 5.4% respectively.

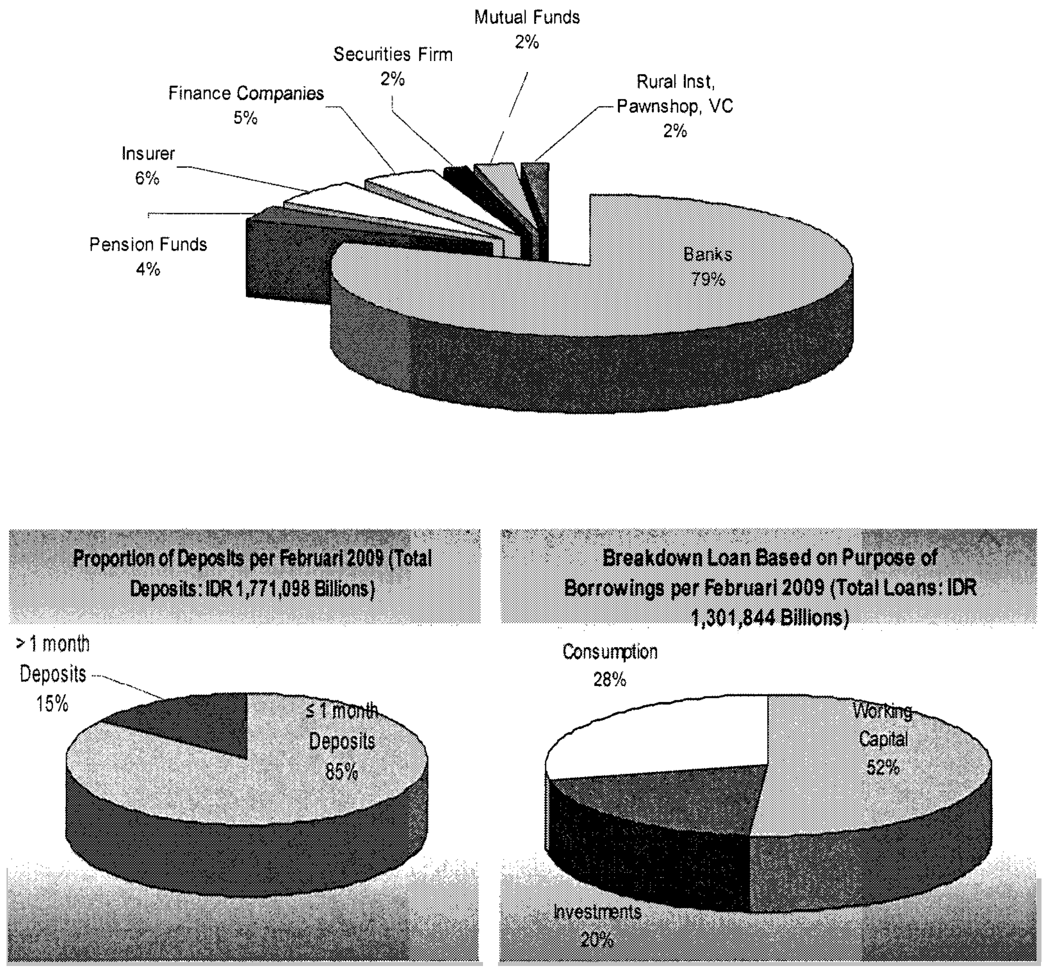
Table 1. Key Financial Indicators of Commercial Banks

	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Feb-09
CAR (%)	19.30	20.52	17.58	17.26	16.76	18.04
NIM (%)	5.70	5.64	5.65	5.73	5.66	5.36
NPL (Gross) (%)	4.07	3.75	3.54	3.32	3.20	3.72
ROA (%)	2.78	2.72	2.53	2.64	2.53	2.6
ROE (%)	17.98	19.00	19.08	18.40	14.38	10.45
Op Ex/Op Inc (%)	84.05	85.19	85.30	83.72	88.59	96.54
LDR (%)	66.32	70.66	73.89	77.72	74.58	73.5
Earning Assets Provision (%)	193.95	147.79	120.77	147.04	168.12	154.53
Deposits (IDR Trillion)	1,510.8	1,466.2	1,554.2	1,603.5	1,753.3	1,771.1
YoY Growth (%)	17 40	13.5	14.7	14.5	16.1	19.9
Loan (IDR Trillion)	1,002.0	1,036.1	1,148.4	1,246.1	1,307.7	1,301.8
YoY Growth (%)	26.5	29.4	33.3	36.3	30.5	29.8
Assets	1,986.5	1,944.7	2,040.8	2,125.4	2,310.6	2,343.7
YoY Growth (%)	17.3	14.1	15.2	14.8	16.3	20.8

Source: Staff estimates using official data from BI and Bapepam-LK.

17. **The structure of bank liabilities remains largely unchanged despite the greater strength and resilience of the banking system.** Over 85% of Indonesian bank deposits are less than one month in maturity (Figure 2). This situation implies that banks cannot make long-term loans to infrastructure projects. In fact, most bank loan portfolios are also short-term, consisting of consumption and working capital loans that are typically less than one year in maturity. Even where longer-term loans are made, they are almost always at floating interest rates. Therefore, commercial banks in Indonesia are unable to provide long-term domestic currency financing to infrastructure projects, even if the projects are well structured.

Figure 2: Financial Structure



Source: Staff estimates using official data from BI and Bapepam-LK

18. **The assets of NBFIs remain small relative to overall financial assets and GDP.** However, this group of institutions has recorded substantial growth rates in recent years. The mutual fund and life insurance industries are the major contributors to the growth of NBFIs, recording particularly strong growth in 2007. The Net Asset Value (NAV) of the mutual fund industry grew by 79% in full-year 2007 to reach IDR92.2 trillion – this after the sector experienced a crisis in 2005 that nearly devastated the sector. Bapepam-LK has made serious efforts to avoid a repeat of that crisis, and investor confidence has returned to the mutual fund industry. In addition, life insurance assets also posted a significant increase - 43.9% annually – to reach IDR102.2 trillion in December 2007. The investment portfolios and gross premiums also increased significantly, by IDR91.8 trillion (47.6% YoY) and IDR45.6 trillion (65.8% YoY) respectively. This impressive growth has been attributed to the public's increasing awareness of life insurance and the popularity of investment-linked products: this market had reached IDR29.3 trillion or 31.9% of life insurance investment by the end of 2007.

19. **NBFIs do not have adequate long-term instruments in which they can invest.** Their asset allocation is skewed towards sovereign bonds and short-term debt instruments.

The growth of the NBFI sector indicates that there is a significant potential demand for well-structured long-term investment alternatives, as NBFIs' liabilities are typically long-term and they look to minimize maturity mismatches through investments in long-term assets.

20. **The financial sector in Indonesia is regulated by two separate entities**: (a) BI, the country's Central Bank, has been independent of the government since 1999 and is responsible for the supervision and regulation of deposit-taking financial institutions (i.e. banks) and authorized money changers; and (b) Bapepam-LK which is responsible for the supervision of all non-bank institutions such as capital markets, pension funds, insurance, venture capital, multi-finance/leasing companies. Bapepam-LK is part of the Ministry of Finance and will be responsible for regulating the IIFF.

21. **Indonesian financial institutions are beginning to feel the impact of the global financial crisis although the sector is still considered stable and sound.** Indonesian banks' direct exposure to troubled American- and European-domiciled banks is limited. Far fewer new loans are being approved and disbursed by Indonesian banks as they adopt more stringent credit norms and maintain higher liquidity. Consequently anecdotal reports suggest that new customers are having difficulty accessing credit from banks. Interbank lending improved between late 2008 and March 2009, and there is sufficient overall Rupiah liquidity in the system. However, the liquidity is not well distributed, with larger banks typically being liquid and smaller banks less so. Further details are provided in Annex 3. There have been some signs of stress in the quality of loans starting from September 2008 that resulted in a slight increase in NPLs. However, this is unlikely to have a substantial impact on the financial health of banks as provisioning and capital is adequate. Credit risk may rise as weakening revenues (especially in export companies) coupled with difficulties in rolling over debt payments adversely affect the financials of some companies. The NAV of mutual funds fell by 20% to IDR74 trillion (throughout 2008). A more substantial decline is seen in life insurance industry with gross premium growth declining from 66% to only 5% (over 2008).

Impact of financial sector structure on infrastructure financing

22. **A major challenge in Indonesia is the shortage of long-term resources needed to appropriately finance infrastructure investment.** Infrastructure projects typically require almost all capital investment to be made before any revenue is generated and may have a "working" life of positive cash flows measured in decades. Even with debt tenors of 10 years and above, debt service will often be the single largest annual project expense and with shorter tenors, debt service can only be met by very high tariffs. Without long-term debt, private infrastructure is unlikely to be competitive. Even if long-term debt is available in foreign currency, the additional risk of foreign exchange losses will dissuade many potential private investors, particularly in Indonesia which has experienced dramatic devaluation in the past (for example: from IDR3,000/US$ to a low of nearly IDR17,000/US$ during 1998- '99). However, long-term Rupiah financing is scarce in Indonesia and limited largely to corporate lending to a few "blue chip" companies. Given the expected stability of their cash flow once they are operational, infrastructure projects must be relatively highly geared to combine low unit costs of delivery (i.e. tariffs) with a reasonable return to the equity investors. In these circumstances, fixed rates are highly desirable as interest rate "spikes" could threaten project viability.

23. **The Government recognizes that local currency financing can be an important public sector risk-mitigation mechanism.** Local currency financing often also requires less public support to mobilize than foreign currency financing. It removes exchange risks from both public and private investors that may act as a significant deterrent to long-term investment commitments to infrastructure. It is therefore in the Government's best interest to develop sound infrastructure financing facilities and bond markets to tap into local currency resources for projects, particularly in sectors where foreign exchange risk is perceived to be high (e.g., transport and water and sanitation).

24. **Through the IIFF, the Government acknowledges that an institutional solution is needed to address the lack of long-term financing for infrastructure projects and to mobilize and lead private capital into commercially-viable infrastructure projects at the national and local level.** A specialized private, non-bank financial institution, the IIFF will expand the role of the private sector in financing and operating infrastructure as similar institutions have done in other countries.

B. Rationale for Bank Group Involvement

25. **The Bank Group is working closely with the Government and key development partners to expand infrastructure provision in Indonesia.** To date, the Bank's focus has been to improve sectoral policies, establish appropriate public institutional mechanisms to support private infrastructure, and improve the overall investment climate. The IFC's work in the infrastructure sector in Indonesia has focused on advisory work (notably in the power sector) to create good-quality contractual structures and an appropriate format for awarding concessions. The creation of a financial institution like the IIFF is the logical extension of the work done to date. As a technically strong independent Indonesian national institution, the IIFF is expected to be particularly effective in pressing for the needed reforms and quality improvements. Even with better concessions, long-term domestic currency financing will continue to be an essential ingredient that the IIFF can provide. The IIFF's ability to support the equity requirements of pioneering projects in itself may prove an important catalyst for other institutional investors.

26. **The Bank Group can leverage its own relatively modest financial support for the IIFF to encourage infrastructure investment.** First, the involvement of the Bank Group brings credibility to such a financial institution and improves private investor confidence. These are key issues in an environment such as Indonesia, where private investors are wary of committing significant long-term resources to infrastructure. Discussions with potential investors indicate that they are willing to consider investing in Indonesian infrastructure if the Bank Group plays a lead role. Secondly, the Bank Group's involvement provides it with a platform to encourage key reforms in the financial infrastructure and capital markets that can ease private financing of infrastructure. Thirdly, through its structuring of the project and ongoing involvement, the Bank Group can help build infrastructure- and project finance skills, areas in which the financial sector is weak. Finally, the catalytic presence of the Bank Group has already helped mobilize other IFIs and development partners in this effort and will also be key to mobilizing resources from private investors.

The Bank's role and expected contribution

27. **The Government has requested the Bank to support its efforts to establish the IIFF.** Close cooperation between the GoI and the Bank on alternative approaches to stimulating private investment in infrastructure led to the formulation of the IIFF concept. The Government values the Bank's continued leadership and ongoing engagement with the IIFF to ensure its success. Given some of the controversy associated with private infrastructure in Indonesia in the past, the Government is looking to the Bank Group to ensure the strongest possible corporate governance standards for the IIFF, as well as ensuring that the IIFF implements strong internal policies and procedures. A reputation for professional excellence and transparency, as well as a long-term development focus is essential if the IIFF is to assume its expected leadership role. A leadership role is essential if it is to achieve the necessary enhancements in project design and contractual structures that will ensure a pipeline of infrastructure projects.

28. **The Bank has already played a significant role in the development of the IIFF.** The Government first raised the idea of establishing an infrastructure financing institution in early 2005, shortly after coming to office. The GoI requested the Bank to support its efforts

to establish the IIFF, and Indonesia's Finance Minister has closely monitored its progress. Because of this high-level engagement, the Project has received strong endorsements from within the Government, the international donor community and multilateral organizations.

29. **The Bank has provided intellectual leadership throughout the project development process.** The Bank is the principal liaison with the Government and has been effective in translating high-level government support into active decision-making at the operational level. The Bank with the Government co-chairs the stakeholder Working Group that has developed the project, and coordinates all grant-funded activities that have been financed by other donors. The Bank has also coordinated the process of bringing to the project several of Indonesia's development partners – AusAID, ADB, and KfW/DEG with IFC leveraging its wealth of experience creating and supporting similar institutions abroad. These development partners, along with the Bank Group, have provided the Government with input on international best practice in this area and provided detailed guidance and advice. The IFIs as a whole have mobilized substantial amounts of grants for the project development effort.

30. **The IIFF will benefit from long-term debt provided by the Government through loans provided by the Bank** (and the ADB). These loans will allow the IIFF to undertake early operations and start funding projects as soon as the right opportunities become available despite turbulence in capital markets. They also provide a layer of capital that can be leveraged through borrowing in capital markets providing a significant multiplier effect to the Bank's loan.

IFC's Role and Expected Contribution

31. **IFC has already played a major role in helping structure the project according to international best practice based on its experience with similar institutions in other countries.** IFC has played a lead role supervising the project's feasibility study, developing the business plan, identifying potential private sector investors and developing an implementation strategy for the Project. Several other benefits are expected from IFC's participation:

- *Seed Capital:* IFC's equity contribution to the IIFF's minimum regulatory capital will help the Project to come into existence and will serve as the basis for further capital increases, which in turn will enable the IIFF to leverage its share capital and build a substantial loan portfolio. A relatively small equity investment will have a significant multiplier effect when it comes to providing financing for the infrastructure sector.
- *Demonstration Effect:* The Bank Group's participation will have a positive signaling effect on other IFIs and the GoI. IFC experience in both the private infrastructure space and in establishing greenfield infrastructure finance institutions are compelling reasons for other investors to participate in the Project, and IFC has provided significant support to the Government on approaching potential private investors.
- *IFC's Technical Expertise* is contributing to the design of the IIFF's shareholding structure and implementation plans. The IIFF's Environmental and Social safeguards Framework (ESSF) will be consistent with IFC's Performance Standards for Social and Environmental Sustainability (IFC PSs), the Bank's safeguard policies, and relevant Government laws and regulations. This is expected to raise E&S standards in Indonesia's new private infrastructure investments. IFC's Integrity Due Diligence (IDD) processes will be factored into IIFF's own processes with regard to subprojects. The selection of the IIFF's management team, the design of credit processes and risk management systems, and the implementing of the IIFF are all areas where IFC, working with the other stakeholders, is playing a leadership role.

- *Guidance through Operations:* IFC will have a seat on the IIFF's Board of Commissioners and will provide guidance and close supervision to the IIFF, particularly in the early operations stage.

C. Link to the Country Partnership Strategy

32. **The proposed project is in line with the Bank Group's Country Partnership Strategy (CPS) for FY2009-12 to invest in Indonesia's institutions.** The CPS explicitly identifies private sector development and infrastructure as two of the five thematic areas that form the core of the Bank Group's engagement in Indonesia[5]. The proposed project is a key component of the Bank's CPS and complements other Bank lending and non-lending activities to significantly improve infrastructure provision and strengthen the financial sector. The establishment of the IIFF is also closely linked to the program of infrastructure reform actions that is supported by the Bank's IDPL series.

33. **The proposed project supports the CPS strategy of "...strengthening the institutions involved, both state and non-state".** The IIFF is a new financial institution that complements the existing financial sector, but at the same time is a unique partnership between the Government, multi- and bi-lateral donors/investors and the private sector, to be managed privately and run along commercial lines with independence and full accountability. Such institution-building is fully consistent with the CPS argument that "Indonesia's main constraint today is ....the need for effective and accountable institutions that can translate available resources into better development outcomes". One of the specific areas of support laid out in the CPS is the IIFF - "the WBG is furthermore supporting the establishment of an innovative infrastructure financing institution that will help to accelerate private investment in infrastructure".

34. **The IIFF fits firmly into IFC's Infrastructure Dept (CIN) strategy for Indonesia.** It reinforces the capacity to structure infrastructure projects, develops long-term local currency lending, and provides for direct financing of infrastructure projects at sub-national levels. This is in line with CIN's strategy in Indonesia to focus on: (i) Sub-sovereign sectors; (ii) Select opportunities in power generation (particularly renewables), coal logistics and transportation, and water; (iii) Providing longer tenor debt, equity and quasi-equity on an opportunistic basis to help sponsors meet strategic objectives; (iv) Investments in an Indonesia infrastructure fund; and (v) collaboration with Advisory Services on financing solutions for infrastructure projects.

35. **The IIFF is also in line with IFC's Global Financial Markets (CGF) department's strategic objectives.** The proposed project will increase the direct flow of financing to a sector that is a critical constraint to growth and raise environmental and social standards in Indonesia's new private sector infrastructure investments. Moreover, the IIFF will make an important contribution to developing long-term lending in local currency, thereby helping to balance maturity mismatches. Through its high local rating and need for long-term funding, the IIFF will also offer alternative long-term investment instruments (e.g. local currency bonds) to institutional investors. This is in line with CGF's five strategic objectives in Indonesia: (i) Increase Access to Finance, (ii) Improve Financial Intermediation,

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[5] Indonesia: Country Partnership Strategy FY09-12 (Report No. 44845-IND), 2008. In addition to its cross-cutting engagements to strengthen central and sub-national government institutions and systems, this CPS identifies five thematic areas that are expected to form the core of the WBG's engagement: (i) Private Sector Development; (ii) Infrastructure; (iii) Community Development and Social Protection; (iv) Education; and (v) Environmental Sustainability and Disaster Mitigation.

(iii) Strengthen and Expand the Social Safety Net, (iv) Develop Capital Markets and (v) Improve the Environment and Environmental Sustainability.

D. Higher Level Objectives to Which the Project Contributes

36. **The project is aimed at helping Indonesia sustain economic growth and poverty reduction in line with the Government's 2004 - 09 medium-term development strategy (RPJM) as well as its commitments under the Millennium Development Goals.** Infrastructure is a key constraint to growth and poverty reduction in Indonesia. Getting substantial investment into infrastructure – in particular private investment - requires significant progress in parallel in several areas: sectoral policies, well-designed projects and concessions, an improved investment climate and institutional capacity in the financial sector that can finance infrastructure. The Bank is already assisting the Government of Indonesia in the first three areas. Ongoing work by the Sustainable Development Unit of the Bank – supported by a series of Infrastructure Development Policy Loans - is aimed at improving infrastructure sector policies, identifying and structuring sound projects, and putting in place a responsible risk management framework. Improving Indonesia's overall investment climate is the focus of the work done by the Bank's Private Sector Development unit. IFC is providing Advisory Services on financing solutions for infrastructure projects. This proposed project aims to complement and reinforce all of these on-going efforts to design and invest in sound private infrastructure ventures.

II. PROJECT DESCRIPTION

37. **The IIFF is the Government's response to the lack of long-term financing for infrastructure projects.** The IIFF will catalyze private investor interest in commercially viable infrastructure projects at both the national and local level by addressing (i) the shortage of specialized project finance and infrastructure expertise; (ii) the design and quality of infrastructure concessions and (iii) ensuring the availability of long-term debt while offering additional sources of equity. It will be majority privately-owned and is expected to earn a commercial rate of return for its shareholders. The IIFF will be established after Board approval and its staffing and final operations manual will be put in place prior to project effectiveness.

Table 2: Investors in IIFF: Ownership Structure (%)

Investors:	Equity Investment at Incorporation in US$ million:	Shareholding at Incorporation:	Projected Investment at Ramp-up in US$ million equivalent:	Projected Shareholding at Ramp-up:
SMI (GOI)	4.03	40.3%	60.0	30.0%
IFC	1.99	19.9%	25.0	12.5%
ADB	1.99	19.9%	25.0	12.5%
DEG	1.99	19.9%	20.0	10.0%
Private Investors	0.00	0.00	70.0	35.0%
Total	**10.00**	**100%**	**200.0**	**100.0%**

Note: IIFF will be incorporated by the IFIs and GoI with a regulatory minimum capital of IDR 100 billion (equivalent to about US$10 million). Equity is expected to reach $200 million equivalent at ramp-up which could occur between year 5 and 7. During this period, private-sector investors are expected to join IIFF and take up a sizeable portion of IIFF's shares. IFIs and GoI are expected to be diluted as private-sector investors acquire stakes in IIFF.

38. **The IIFF will be commercially oriented with private sector governance, mandated and equipped to mobilize local currency private financing of the right tenor, terms and price for the development of creditworthy infrastructure projects in Indonesia in at least three ways:** 1) by using its balance sheet structure and good credit rating to borrow from the private debt market, in particular from institutional investors and then lending these funds to individual projects on terms appropriate for private, commercially funded infrastructure projects, preferably on a co-financing basis mobilizing other sources of financing; (2) by providing financial products to enhance the credit of individual infrastructure projects and thereby mobilize additional financing for those projects, and (3) providing advisory services and assisting in the creation of bankable infrastructure projects as well as policy support, where necessary.

39. **The challenge for the IIFF is to convert a set of potential projects into a pipeline of projects eligible for the IIFF financing.** Some of the constraints are already being addressed (e.g. through the land acquisition initiatives and better adapted bidding procedures) although implementation of some is still an issue. Others such as the development of a strong indigenous infrastructure advisory capacity and long-term, fixed-rate Rupiah financing, have barely begun. The IIFF will combine access to long-term financing with technical expertise and a strong commercial focus to support increased levels of private investment in infrastructure. A preliminary assessment of the pipeline of potential projects for

IIFF indicates a total universe of 340 projects, with a value of over US$76 billion that would in theory fall within the mandate of the IIFF[6].

40. **The IIFF's advisory role is expected to be an important element of its business strategy, leading to the emergence of bankable projects for funding.** The IIFF will work to create bankable infrastructure projects that can reach financial close by offering advisory services relating to policy reform, project preparation, transaction and bidding structures. As an entity with the active support of GoI and the IFIs promoting policy reforms in infrastructure, IIFF is expected to establish itself as the preeminent focus of expertise in Indonesia on infrastructure policy and regulation, and on the requirements of commercial transactions. IFC's experience in the sector in Indonesia suggests that this will be a critical factor in building a project pipeline. The IIFF will help generate commercially viable infrastructure projects through its advisory arm, providing practical advice to the Government on issues such as the design of "model" concession contracts for various sub-sectors (e.g. ports, municipal water). The IIFF is expected to contribute to ongoing policy reform initiatives, play a role in project development, establish itself as a national repository of skills and experience relating to PPP projects and create funding opportunities for other investor classes. Indeed it is possible that the advisory activities of IIFF may be its principal business in the initial phase of its operations.

41. **The IIFF will hire experienced infrastructure finance specialists to manage its operations and will implement international best practices in relation to risk and financial management and advisory services.** It will adopt corporate governance practices to confirm its position as a credible institution in the eyes of all stakeholders. The infrastructure projects the IIFF finances will also conform to and implement social and environmental safeguard policies and standards, and other key issues specific to the sustainability of its project portfolio that have jointly been agreed upon between the institutions involved in its establishment, including the GoI. The presence of commercial banks or other private financial institutions in the equity and on the Board of the IIFF will further help it maintain a commercial focus.

42. **To ensure high quality senior management and human resources, the IIFF will offer compensation that is in line with the market and effectively linked to performance.** The IIFF will seek professionals who are passionate about making a difference and committed to meeting the challenge of leading private capital to infrastructure. Having a passionate, skilled and self-motivated President Director and core teams is important. IFC has provided grant financing for an executive search firm to hire this initial team. To the extent that it is not possible to house the entire set of skills required for the development and implementation of private infrastructure projects in-house, the IIFF will actively develop a database of external experts with whom the company will develop a working relationship in the course of its operations.

43. **The current global financial crisis and credit crunch may, in certain important respects, support the launch of the IIFF.** The capacity of local banks to provide long-term financing is limited. The subordinated financing being made available now through the Bank and ADB places the IIFF in a particularly advantageous position. Initially seen as one of the great challenges facing the IIFF, the recruitment of key executives and particularly of a CEO with a strong reputation with infrastructure investors, the financial sector and the Government, is now easier.

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[6] An AusAID funded consulting firm undertook a detailed feasibility study for the project, part of which was the estimation of the potential pipeline of projects for IIFF. The full feasibility study is available in the project files.

44. **The IIFF will mobilize local currency debt, reassure local financial markets and help institutional investors place their funds in credit worthy long-term Rupiah investments which have not been available to them until now.** While international private investors may take a more cautious view of the IIFF due to the global financial crisis, preliminary discussions suggest that once the IIFF is established, investor interest will be there. At a later stage, investors with resources to commit to infrastructure, but without the internal capacity to develop or arrange infrastructure projects, (insurance companies, other institutional investors, possibly Sovereign Wealth Funds) will provide the opportunity for the founding investors, including the Government, to reduce their holding with an attractive return. Such returns will also stimulate new sources of private participation in infrastructure. As its market becomes more competitive, the business model of the IIFF will evolve, with early stage equity investment, syndication and management of infrastructure funds likely to provide new sources of revenue.

45. **Overall, the IIFF is designed to be a transformational constraint-alleviating entity that will have a significant impact on development.** The IIFF will address key weaknesses in Indonesia's financial sector and complement the role of existing financial institutions. Through its lending products, it will catalyze long-term financing for commercially viable infrastructure projects. It will provide Indonesia with a domestic center of project finance expertise and thereby address a key capacity constraint in the market. Using these high quality skills, the IIFF will also support ongoing and future Government initiatives by providing advisory services in key areas including in the development of a sound project pipeline.

46. **While it will begin small, over a 3-5 year period the IIFF projects an equity base of US$200 million, and long-term subordinated debt of US$200 million from the Government.** The IIFF is projected to leverage this total capital of US$400 million to raise more than US$1 billion more from domestic and international capital markets over 4-6 years. The IIFF will primarily finance commercially viable private infrastructure projects. It may also consider financing commercially viable projects with the participation of sub-sovereign governments and SOEs, up to an aggregate cap of 20% of its assets size for such investments. It will take project-related risks on its own balance sheet with no further recourse to any of its shareholders (including the Government).

47. **The Government is well advanced in the establishment of the IIFF and has obtained parliamentary approval to invest up to IDR1 trillion in infrastructure financing institutions.** Of this amount, it will invest up to IDR 600 billion (US$60 million equivalent) in the IIFF – which would make it a significant minority, stakeholder. It has committed itself from the outset to ensuring that the IIFF will be a commercially-run private sector entity. A substantial minority stake (Government is aiming at around 30 % after inducting private investors) will be retained to reflect the Government's commitment to the new institution. It has formally approached IFC and KfW/DEG for equity investments in the IIFF, and the ADB and the Bank for a total loan of $200 million ($100 million from each) to provide a subordinated loan to the IIFF. The Government has established PT. Sarana Multi Infrastruktur (SMI) as the vehicle through which the Government's investments in loans and equity to the IIFF are to be channeled, and transferred IDR1 trillion to SMI as its equity contribution[7]. A presidential regulation that enables the establishment of infrastructure financing companies – that will also govern the IIFF – has been issued[8]. It has expressed its intention to have the IIFF established mid-2009.

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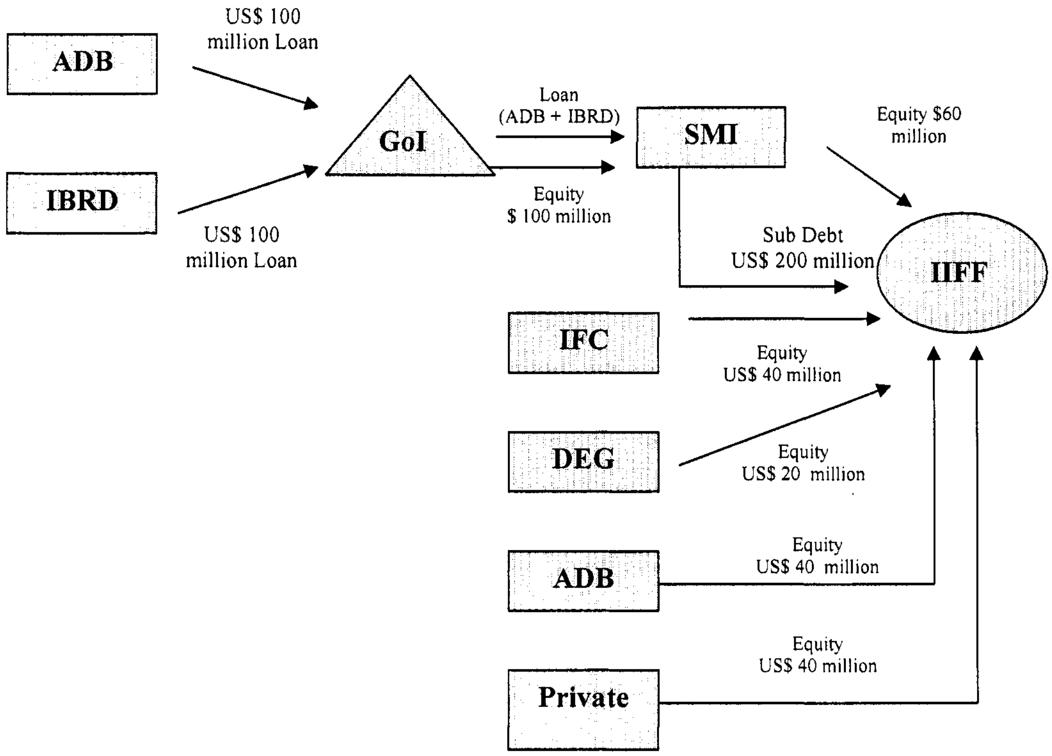
[7] See Para 64 for details on SMI.

[8] Peraturan President No. 9/2009 dated March 18, 2009.

Figure 3: Structure of the IIFF



Note: US$ 40 million in GOI equity, provided to SMI, will remain in SMI for other purposes; US$ 60 million will be invested by SMI in IIFF.

A. The Bank's Lending and IFC's Investment Instruments

48. **The Bank's lending instrument for this project is a Financial Intermediary Loan, or "FIL".** The Bank will provide an investment loan to the Republic of Indonesia as the Borrower. The Borrower will in turn provide these funds to the IIFF – the sole participating financial intermediary – through SMI. The IIFF will in turn, use these funds to provide predominantly long-term loans, guarantees, equity investments and other financial products as well as advisory services to commercially viable infrastructure projects. Under applicable local regulations, the IIFF will be able to count the funds provided by the Bank (and the ADB) as part of its overall capital base and leverage the funds (up to 5 times) through borrowings from the local financial markets and on-lend borrowed funds to infrastructure projects. The Borrower has requested an IBRD variable-spread loan denominated in US dollars with a final maturity of 24.5 years including a grace period of 9 years.

49. **IFC will invest up to an equivalent of US$40 million in the IIFF's common equity.** This equity investment will be carried out over an expected time period of 5 years. At the incorporation of the IIFF, IFC will participate in the initial subscription with around US$2.0 million (equivalent). This will give IFC a 19.9% ownership stake and equip the IIFF with the minimum regulatory capital of IDR 100 billion (equivalent to about US$10 million). As the IIFF's asset base grows over time, IFC and other investors will subscribe in subsequent rights issues until the IIFF's capital reaches US$200 million. Subsequent capital calls will be triggered if the IIFF reaches certain financial benchmarks (e.g. leverage ratios, growth targets), and if the IIFF needs to buttress its asset growth with additional capital. At no time during its investment will IFC own more than 19.9% of the IIFF's shares.

B. Project Development Objectives and Key Indicators

50. **The objective of the Project is to strengthen and further develop the institutional framework of the financial sector to facilitate financing of commercially viable infrastructure projects and thereby increase provision of private infrastructure in Indonesia.** The IIFF is expected to achieve the objective by building the necessary capacity and skills, and providing long-term financing, innovative financial products, and advisory services. The IIFF's ultimate objective is to increase the provision of infrastructure in Indonesia to support a more inviting investment climate, sustained growth, and poverty reduction in the long-term. The project aims to support the establishment of the IIFF to mobilize capital from domestic and international sources and make it available to commercially viable infrastructure projects. The IIFF will provide direct financing and credit enhancements to mobilize private participation. The project also aims to improve the institutional and legal/regulatory framework within which private infrastructure financing occurs on a sustainable basis. This will be accomplished through the incentives created by the availability of debt for well-designed projects and through the IIFF's advisory function, which provides access to the IIFF's infrastructure financing experts with good knowledge of the Indonesian context.

51. **A detailed Results Framework has been developed (Annex 6).** Examples of key performance indicators to judge the IIFF's success include: (i) an increase in the number of commercially viable infrastructure projects achieving financial closure through long-term debt financing, other financial products, and advisory services from the IIFF over the life of the project; (ii) an increase in the amount of private capital (including long-term debt and equity) available for infrastructure projects over the life of the project; (iii) increased support to the Government's policy-making relating to the provision of infrastructure by the private sector through the use of the IIFF's advisory services; and (iv) an increase in privately financed infrastructure in Indonesia.

52. **The IIFF's development impacts will also be tracked by IFC through the development indicators listed in Table 3 below:**

Table 3: Financial and Economic Returns

Rate of Return	Key Indicator	Frequency of Monitoring	Source
Return on Equity ("RoE")	Expected RoE of 15.4% to exceed the cost of equity by 6.9% within 6 years (2009 through 2015) of IFC's commitment.	Annually	Consolidated Financial Statements
Economic Return on Equity ("ERoE")	Expected ERoE of 22.5% to exceed the cost of equity by 13.9% within 6 years (2009 through 2015) of IFC's commitment.	Annually	Consolidated Financial Statements

53. **In addition, the IIFF will have a number of development impacts not captured in the ROE and EROE calculations.** Indicators related to these development dimensions will also be tracked in IFC's Development Outcome Tracking System ("DOTS") during supervision (see Table 4 below).

Table 4: Development Impact Indicators

Impact	Impact Indicators	Frequency of Monitoring	Source
Infrastructure Loan Growth	Increase the infrastructure loan portfolio to US$300 million by 2014 and to US$1.5 billion by 2019.	Annually	Audited Financial Statements
Loan Portfolio Quality	Keep the NPL ratio below 6% and reduce to 3% by 2014.	Annually	Audited Financial Statements
Improve Regulatory Framework for Private Infrastructure Participation	Engage with GoI to reform the regulatory framework and work on at least three initiatives per annum in each of the years up to 2012.	Annually	Annual Operations Report
Implement and Operate E&S Management System	Introduction and application of a common ESSF acceptable to the Bank Group in the IIFF's operations by the end of 2010.[9]	Annually	EMS Report

C. Project Components

54. **The project will have one component each from the Bank and the IFC: an investment loan by the Bank that will be made available to the IIFF as subordinated debt to be used for eligible infrastructure projects and an equity investment by IFC in the IIFF.** The Bank Group – along with other development partners involved in the project – will approve an Operations Manual that will form the basis for the IIFF's decision-making regarding the specific projects it chooses to support and the instruments that it selects to provide such support. The Bank Group will not be involved in approving individual IIFF sub-projects. However, intensive supervision will be conducted over the life of the project. (see Paragraph 81-82 for details). The Bank's loan is expected to be fully disbursed over a four-year period (FY 2010-2013) while IFC's equity investment is expected to be fully made over five years (See Annex 12).

D. Lessons Learned and Reflected in the Project Design

55. **The project design reflects lessons learned from recent analysis of the investment climate, infrastructure provision, and the financial sector.** Specifically, Bank analytical work in the financial sector shows that there is limited capacity to provide long-term local currency debt to private infrastructure projects. This capacity is likely to be built only gradually as Indonesia's financial sector becomes more diversified from a bank-

[9] The adoption of an Operations Manual by IIFF based upon a commonly agreed ESSF that is in compliance with Bank Policies and IFC PSs, the GOI's applicable laws and regulations and in accordance with the recently approved "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC, and/or MIGA" (dated January 21, 2009) is a condition of effectiveness of the Bank's loan.

dominated system to one that has a greater role for capital markets and non-bank financial institutions. In the interim however, there is a need for an institution such as the IIFF to provide appropriate financing to commercially viable projects.

56. **The project design also incorporates lessons learned from the Financial Intermediary (FI) lending review completed by the Bank's Internal Evaluation Group[10].** The key success factor attributed to such loans by IEG is adherence to OP8.30 guidelines, with which the project complies[11]. Key areas of guidance provided by OP 8.30 have been taken into account. The proposed build up of assets by the IIFF has been jointly developed by the Bank-IFC teams and is conservative with regard to the adequacy of capital and risk management policies and the capacity of the IIFF. The Government is putting in place specific regulations governing the activities of infrastructure financing institutions under which the IIFF will be regulated and supervised. The capacity of Bapepam-LK is being strengthened through on ongoing program of assistance by AusAID, who are also funding a significant portion of the IIFF's project preparation costs. The Bank will continue to coordinate with AusAID and other partners on key issues in NBFI sector development. Capacity building of IIFF will occur primarily with its own funding complemented by any available financing from development partners. The Bank's ongoing analytical work on improving the environment for infrastructure PPPs, and capacity building for PPP in various line agencies will also support the Project.

57. **The project design also benefited from lessons learned from similar infrastructure financing projects financed by the Bank in India, Bangladesh, Morocco, and Poland (Annex 4).**[12] One important lesson from these projects is the need for the IIFF to have a pipeline of potential projects. The Bank Group team's detailed review of the potential project pipeline (Annex 6) concludes that there are significant IIFF investment opportunities. Taking into account that Indonesia's private sector infrastructure program is still in its infancy, and the fact that the IIFF is itself expected to play a significant role in the future development of the pipeline, the team has deliberately assumed a slow rate of growth for the IIFF's balance sheet.

58. **The IFC team has drawn lessons from experience with bottlenecks in infrastructure provision in other markets and from establishing greenfield financial institutions**. India's experiences with the IDFC are considered particularly relevant. Infrastructure experience highlights the importance of well-structured projects and contracts, the contribution that advisory services can make at both the Government level and through individual transactions, and the value of long-term, fixed rate, domestic currency financing to private infrastructure financing and to the development of an economy's financial sector. The critical importance of the choice of a CEO, the need for flexibility to adapt to changing circumstances and the capacity of a well-selected Board to steer the new institution stand out as important lessons learned from the creation of new financial institutions in the past.

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[10] "World Bank Lending for Lines of Credit: An IEG Evaluation," 2006, http://siteresources.worldbank.org/EXTFINSEC/Resources/lines_of_credit.pdf

[11] Documents relating to the OP 8.30 compliance and clearance of the Regional reviewer are available in the project files.

[12] India - Tamil Nadu Urban Development Project (I, II, III) - (P009872), (P050637), (P083780); India – ILFS: Private Infrastructure Finance (P039935); Bangladesh - Investment Promotion Financing Facility (P089382); Colombia – Private Infrastructure Financing Facility (P052681); Morocco – Municipal Finance (P005523); China – Energy Efficiency Project (P084874) ; Poland – Municipal Finance (P035082); Russia – Coal and Forestry Sector Guarantee Facility (RU-GU-57893; RU-GU-60045).

E. Alternatives Considered and Reasons for Rejection

59. **Given past experience and the needs of the GoI, a number of alternatives were considered and rejected, in particular:**

- A state owned enterprise providing financing directly to projects. This "DFI" approach was rejected due to challenges in insulating the entity from political interference, or perceptions thereof, and creating a management function with relevant experience and resources.
- Using an existing bank, financial institution or fund manager to on-lend public funds to projects. This was rejected as it fails to achieve leverage from other sources of debt, there is a distinct shortage of capacity and infrastructure finance experience in Indonesia, and the approach might create conflicts of interest for the chosen entity, which will likely be a key potential investor. It may be a viable alternative for smaller economies that do not have sufficient volume to support a new specialist institution.

60. **The decision to support the IIFF was also driven by the fact that the Government views it as a key national institution that will facilitate long-term financing for commercially viable infrastructure projects.** The fact that the Government has agreed to take a significant minority equity stake, invited a number of development partners to support the IIFF, and has committed itself to the establishment of the IIFF in a number of policy pronouncements and IDPLs, all indicate its ambitious mandate for the IIFF.

III. IMPLEMENTATION

A. Partnership Arrangements

61. **The Bank Group has collaborated closely with various development partners on this project.** It should be seen as an integrated package of support by the Bank Group. The Bank has taken the lead in infrastructure and financial sector policy reform efforts, both of which are an integral part of the Bank's country dialogue. IFC focused in particular on the shareholding structure, the development of the business model and attraction of private investors to the IIFF, and the challenge of launching the new institution.

62. **Development partners have contributed significantly in the preparatory phase of the IIFF.** An IIFF feasibility study, detailed institutional design (including preparation of the Operations Manual) and the early coordination of investors was funded by AusAid grants totaling over A$1 million. The establishment of the IIFF requires a new regulatory framework and the resolution of several outstanding legal issues that are being addressed through a US$100,000 ADB grant. Recruitment of the CEO, and the rest of the senior management team is likely to have a significant impact on the success of the new institution. Recruitment of a CEO with the stature required before a Shareholders' Agreement has been signed and the new institution legally established, will be difficult. IFC has provided grant funding of US$150,000 to identify and hire the IIFF management team. A shortlist of candidates has been circulated to the stakeholders and discussions and selection will follow Board approval. Meanwhile, a Project Management Office (PMO), funded initially by DEG and AusAid and run by a small international team already familiar with both Indonesian infrastructure and the operation of PMOs for infrastructure programs, will soon begin coordinating the many elements required for the launch of the new institution.

63. **Development partners have also indicated a willingness to make significant financial commitments to the IIFF.** The ADB proposes making an equity investment of US$40 million and a loan of US$100 million in support of the IIFF: its Board has approved these investments on March 31, 2009[13]. DEG is in the process of obtaining internal approvals for an equity investment of up to US$20 million. The Government is contacting private investors – domestic and international – and some positive preliminary indications of interest in providing equity investments have been obtained. However, even without the current global financial crisis (which makes obtaining equity investment from private investors more challenging), it is realistic to expect that the IFIs and the Government will establish the IIFF, and that private sector investment will follow. The team expects that within a year of its launch, the IIFF will have some private equity participation and representation on its Board, and the Shareholders' Agreement is being designed to accommodate this.

B. Institutional and Implementation Arrangements

The Role of PT. Sarana Multi Infrastruktur (SMI)

64. **The Government has established the fully publicly-owned holding company PT. Sarana Multi Infrastruktur (SMI) as the vehicle through which it will invest in the IIFF.** SMI is a 100% State Owned Enterprise under the Ministry of Finance whose purpose is to invest in infrastructure financing institution(s) or otherwise provide funds for infrastructure financing. The Government has allocated an initial capital commitment of IDR 1 trillion to SMI through the national budget approved by parliament. Of this amount, SMI will invest

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[13] ADB document No. P42109-01, Report of Recommendation of the President to the Board of Directors on Proposed Loan and Equity Investments, Republic of Indonesia: Indonesian Infrastructure Financing Facility.

IDR 600 billion (equivalent to about US$60 million) in the IIFF for a minority equity stake on behalf of the Government. This will be invested initially pro-rata with the IFI investors, with a combined initial investment of IDR 100 billion (approximately US$10 million equivalent)[14]. With IFC, ADB and DEG initially investing 19.9% each, SMI will initially contribute just over 40% of the common equity. The balance of the US$60 million, pending its being paid in as equity, will be contributed as convertible subordinated debt, earning a return based on current market rates. As private investors join the equity, SMI will reduce its percentage stake (in absolute terms, its equity contribution will grow) to 30%. Further private investment beyond that point will lead to a dilution of the IFI holdings. The balance of SMI's funding will be applied in complementary efforts to develop private investment in infrastructure. The equity investors are developing an approach for such efforts of SMI for discussion with the Government. It is likely that SMI would potentially support project preparation (eg. In the municipal water sector) that could be considered by IIFF. SMI could also potentially make some investments alongside IIFF as a means to develop expertise in infrastructure sectors.

65. **SMI will also channel the Bank's and ADB's sovereign loans to the IIFF.** The terms and conditions of this pass-through will be back-to-back, with fees, margins and other costs at cost-recovery levels with no subsidies involved. They will also include fiduciary and implementation undertakings by SMI commensurate with those contained in the Bank's legal agreements with the GoI. SMI has been established with a lean staffing and management structure, with a Board of Commissioners and a Board of Directors reflecting its role as an investment vehicle for the Government.

Regulation of IIFF

66. **The IIFF will be regulated by Bapepam-LK within the broad framework of regulation of non-bank finance companies.** A Presidential decree authorizing the establishment of infrastructure finance companies in Indonesia has been issued. A Ministerial decree that operationalizes the Presidential decree and sets out requirements such as minimum capital, reporting requirements, lines of business that can be undertaken, etc. has also been issued.

Executing Agency

67. **The office of the Directorate General of State Assets, Ministry of Finance, will be the Executing Agency for the Bank's loan.** DG Treasury will be responsible for the execution of the subsidiary loan agreement between the GoI and SMI and for processing and transferring loan funds to SMI.

Funds Flow and Disbursement Arrangements

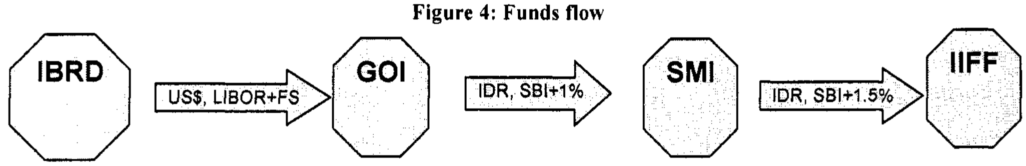
68. **Drawdowns from the loan will be made on the basis of requests from the IIFF to SMI, which in turn will be transmitted to the Government, and the Government will request the Bank for drawdowns.** Bank funds will be provided to the Government, which will on-lend to SMI (see Figure 4 below) through a subsidiary loan agreement. The SMI will provide these funds to the IIFF through a subordinated loan agreement. Indonesia will borrow from the Bank in US$ using the VSL: the GoI will provide equivalent IDR funds to SMI at its standard interest rate for such subsidiary loans (applicable to all state owned enterprises) at 1 month SBI+ 1%. The difference between this rate and the Bank's lending rate to Indonesia effectively represents the premium charged by the Government for taking on the exchange rate risk. SMI in turn will add a spread (0.5 percent) towards its administrative expenses and

[14] In line with the business growth of IIFF, this equity will be built up to $200 million.

on-lend these IDR funds to the IIFF[15]. There are no subsidies being provided to the IIFF and it will raise its funds at rates comparable to the market.

69. **The subsidiary loan agreement and the subordinated loan agreement will contain undertakings by SMI and IIFF, respectively, to implement all fiduciary and implementation undertakings made by GoI to the Bank.** The Bank's loan to GoI, as well as the subsidiary loan agreements will also contain a subordinated debt to equity ratio of 2.5 to 1 that will contractually ensure that sufficient equity capital is provided to the IIFF by its shareholders[16].

Figure 4: Funds flow



70. **The applicable disbursement methods include:** 1) Advance, 2) Reimbursement, and 3) Direct Payment as referred to in the WB Guidelines for projects dated May 1, 2006. In order to facilitate disbursements under the Advance method, SMI will open a deposit account[17] in a commercial bank acceptable to the Bank. The account will be denominated in Rupiah and will be solely used to finance eligible subproject loans, equity, guarantees and/or other financial products expenditures. The ceiling of the advance to the account is fixed at US$10 million. At the initial stage of the project, a smaller advance may be deposited to the account, but should there be a need to have an advance beyond the applicable ceiling at later stage, SMI should request to the Bank to increase the ceiling with justifications. The IIFF will submit request for payments to SMI against subproject loans, equity, guarantees and/or other financial products and will be paid by SMI from the deposit account. SMI will ensure that the account will only be used to finance eligible subproject loans. SMI will be responsible for reporting the use of funds in the account and preparing the application for withdrawal for advances, duly approved by MOF DG Treasury (DSMI) and KPPN Jakarta VI before their submissions to the Bank. Applications for reporting the use of the funds would be supported by a: (i) statement for the subproject loans' drawdown, (ii) reconciliation statement of account; and (iii) a copy of the bank account statement. Reporting on the use of the account and application for an advance to the account may be submitted in a single monthly application.

71. **SMI may at its option, make payments against a eligible subprojects' loan, equity, guarantees and/or other financial products and request reimbursement from the Bank by submitting the relevant application for withdrawal supported by** (i) a statement for the subproject loan's drawdown and (ii) evidence of payments made. SMI may also forward requests for larger payments for subproject loans drawdown to the Bank for payment to be made directly to the subproject loan, equity, guarantees and/or other financial products

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[15] The net spread charged by SMI to IIFF will be 0.5 percent over the cost of funds that SMI receives from the Government. In addition, the subordinated loan agreement will specify a formula by which SMI will be entitled to recover any actual tax payments that it may incur as a result of the lending to IIFF.

[16] This ratio is based on the financial projections for IIFF.

[17] This account is defined as the Designated Account referred to in Section 5 of the WB Disbursement Guidelines for Projects, May 1, 2006

beneficiary by submitting an application for withdrawal supported by records evidencing eligible subproject loans. These disbursement methods are subject to a minimum value of US$100,000 (equivalent) per application.

72. **In line with government procedures, the above three disbursement procedures will be categorized as "PL" (*pembayaran langsung*).** All applications for withdrawals initiated by SMI will be submitted to MOF DG Treasury (Directorate SMI) for issuance of SPM-PP (payment order), and then to KPPN Jakarta VI for issuance of SP2D-PP (remittance order). These steps are to record the drawdown in the budget document (DIPA-PP) and to record the sub-loan realization to SMI. KPPN Jakarta VI will be authorized to sign the application for withdrawal for submission to the Bank.

Table 5: Allocation of Loan proceeds

Category Description	Amount of Loan(US$)	% of expenditures to be financed
IIFF investments in sub-projects	100,000,000	100%
TOTAL	100,000,000	

Governance and Accountability

73. **A sound governance structure is key to the success of the IIFF.** Substantial multi-, bi-lateral, and private sector (domestic and international) equity participation will drive sound governance. The IIFF will adopt corporate governance practices to confirm its position as a credible institution in the eyes of all stakeholders. To improve transparency, the IIFF will also voluntarily comply with the listing requirements of the IDX from the outset, even though it is expected to be listed only in the medium-term. Annex 11 describes a detailed Governance Action Plan.

74. **The project design recognizes that the infrastructure industry in Indonesia is at high risk for corruption.** A study done by the Commission for the Supervision of Business Competition (KPPU) finds that corruption risks in infrastructure are high, particularly in the water and sanitation, and transportation sectors. Law enforcement investigations into corruption cases in the electricity, oil and gas, and telecommunication sectors have proven them also to be at risk. To prevent the IIFF being tainted by corruption, appropriate prevention measures need to be designed and implemented. Given that the IIFF will be a private company established under Indonesian Company Law and will operate in the Indonesian business environment, the corruption prevention measures will be designed accordingly. These measures will be incorporated into the IIFF's Articles of Association (to the extent permitted by Indonesian law), Shareholders' Agreement, Operations Manuals (including the sections on Human Resources, Procurement and Credit), all of which will be adopted by the IIFF prior to project effectiveness.

75. **As the IIFF is a private company, the Board of Commissioners (BOC) will be tasked with reviewing company risks, developing recommendations for risk mitigation and overseeing their implementation on a regular basis.** To execute the task, the BOC will be authorized to establish committees under its control comprising people with relevant expertise. The risks considered will cover governance and corruption risks[18]. It is expected that the IFC, ADB, and DEG will nominate one member each and SMI will nominate two

[18] Governance mechanisms to address procurement, financial management, and environmental and social issues are addressed in the respective sections below.

members to the IIFF Board of Commissioners, supplemented by highly reputable independent Commissioners as necessary. This Board will provide credibility to the IIFF and play a vital role in corporate good governance.

76. **Corruption-related issues will be addressed in at least two ways.** First, the founding Shareholders are ensuring that the IIFF is subject to high standards of governance and that it institutes anti-corruption processes and systems. A Shareholders' agreement currently being drafted will be signed by all the shareholders – the ADB, IFC, DEG, and SMI – after Board approvals are obtained. This agreement provides that the shareholders shall ensure that the IIFF is not involved in "sanctionable" practices – which by definition includes "Corrupt Practices", "Fraudulent Practices", "Coercive Practices", "Collusive Practices" and "Obstructive Practices" and contains references to compliance of the IIFF with Indonesian law. These definitions are in line with the Bank's guidelines as well as relevant Indonesian laws. The adoption of this Shareholders' agreement is an effectiveness condition for the Bank's loan.

77. **Secondly, the subsidiary loan agreements between the Government and SMI**, and the subordinated loan agreement between SMI and the IIFF will include all fiduciary and implementation undertakings made by the Government to the Bank. The Bank retains the standard remedies that it has in its agreement with the Government in the event that Bank funds are found to have been abused either by SMI or by the IIFF.

78. **The IIFF will have mechanisms to insulate it from political pressures.** The Government has recently demonstrated its willingness to make difficult decisions to ensure sound governance in the financial sector. Specific actions have included corruption investigations – and convictions – of senior management of a large state owned bank and senior officials of the central bank (some investigations are ongoing). The IIFF will build on the momentum that has been generated as a result of these actions. The Government has repeatedly indicated that it would like to ensure the operational independence of the IIFF and that the strong presence of institutions such as the Bank Group – and others involved – would greatly help in the process.

79. **To ensure no conflicts of interest between the different functions the IIFF will perform** (e.g. broad advice to the Government on contractual structures, project advisory, and project equity and debt financing), the IIFF will create fire-walls between functions with potential conflicts of interest to ensure that no employee involved in the project finance function simultaneously works on policy advisory or project development mandates. The teams involved in policy reform and project development will be discrete and separated from the teams involved in project finance operations, reporting to separate top-level directors. IFC's experience separating advisory from financing roles is expected to be particularly relevant.

Operations Manual

80. **An OM acceptable to the Bank is being prepared for adoption by the IIFF.** The OM will include, *inter alia*; the policies and procedures to be followed by the IIFF to address operational, credit and foreign exchange risks in its day-to-day operations; agreed financial management, procurement, and disbursement policies and procedures; environmental and social policies and procedures to be followed in line with the Bank's policies, IFC's Performance Standards and applicable Indonesian laws and regulations; a detailed framework for the measurement and monitoring of outcomes; guidelines on preventing fraud and corruption in line with WBG policy; the supervisory arrangements for the project; and terms and conditions for agreements between IIFF and subproject companies reflecting all the above. These are all key elements in ensuring effective project implementation. The adoption of an Operations Manual acceptable to the Bank is a condition for effectiveness of the loan. The adoption and on-going application of the operations manual

is a covenant in the Loan Agreement between the Government and the Bank and the Project Agreement among SMI, IIFF and the Bank, and will be included in the subsidiary loan agreement and subordinated loan agreement from the Government to SMI and from SMI to IIFF, respectively.

Project Supervision

81. **The IIFF will be established once the approval of all development partners for their equity and loan commitments has been obtained.** While the OM will lay out the procedures that the IIFF will follow, and while this obligation will be included in the legal agreements, project supervision will have to ensure that it is following the established norms. It is expected that in the initial stages this project will need intensive supervision, at least until the IIFF has established itself. Bank supervision will need to focus on (i) the Government's role in the IIFF and in its requests to the Bank for drawdowns of loan funds (ii) SMI's role in the IIFF and in passing-through Bank funds to the IIFF (iii) the IIFF's adherence to the OM and its overall functions and (iv) development outcomes in the form of the performance of projects financed by the IIFF. To provide the context for this supervision, the Bank's project supervision team will need to coordinate closely with the team working on broader infrastructure sector issues, especially as they relate to the framework for private participation in infrastructure, and with the IFC supervision team.

82. **IFC's supervision will begin from first equity disbursement and continue on a quarterly basis for as long as IFC remains an equity investor.** It will focus on the detailed monitoring of operational performance, management quality, environmental outcomes, compliance with each covenant of the Shareholders' Agreement (and by association, the Articles of the IIFF), adherence to integrity standards, financial results, the evolution of the valuation of the equity holding, and a comparison of expected and actual development outcomes.

Bank/IFC Conflicts of Interest

83. **The Bank and IFC teams are consulting with the World Bank Group Conflicts of Interest Office (WBGCOI)** regarding the possibility of potential or perceived conflicts of interest arising in relation to the two institutions' participation in the Project, viz. establishment of the IIFF. The Bank's funds will be provided to Indonesia; these will in turn be on-lent to IIFF (through SMI) as subordinated debt. IIFF will on-lend these funds to eligible infrastructure subprojects. The terms and conditions of the Government's subordinated debt to IIFF will mirror the terms and conditions of the Bank's loan to Indonesia. IFC, on the other hand, plans to invest $40 million directly in the common equity of the company. In the view of WBGCOI, the collaboration of the Bank and IFC in the Project is not likely to raise significant conflicts of interest risk, except in circumstances where financial condition of the IIFF materially deteriorates. Under such circumstances, given that the terms and covenants of the Bank's loan to Indonesia, and Government's sub-debt to the IIFF (through SMI) are substantially the same, any requests for waivers of covenants and terms under the subordinated debt by the IIFF would likely trigger a de facto mis-alignment of interest between the Bank and IFC. Accordingly, the WBGCOI Office advised the Bank and IFC teams to put in place conflict mitigation measures, including establishing separate teams with no overlapping members to handle the Bank's and IFC's respective investments in the Project, and adopting appropriate information barriers to prevent sharing of confidential information between the teams without appropriate consents. In response to this advice, the Bank and IFC have agreed that there will be separate teams as suggested. The teams would continue discussions with WBGCOI and arrive at agreements on appropriate information sharing keeping in mind confidentiality and conflict of interest aspects on one hand and the synergies and reduced transactions of joint-supervision (to the extent practical) on the other. WBGCOI also advised the teams that these arrangements be disclosed to the Government, IIFF and other stakeholders in writing and the teams have

agreed to do so after these arrangements have been agreed upon. The team will continue consulting with the WBGCOI Office as the project progresses and will implement appropriate conflicts of interest mitigation measures based on WBGCOI Office recommendations.

C. Monitoring and Evaluation of Outcomes and Results

84. **A sound monitoring framework to track inputs, outputs and outcomes in a systematic and timely fashion has been developed and has been agreed with GoI.** Project outcomes and outputs will be monitored via project supervision using administrative data from several sources. The IIFF will have its own dedicated M&E unit, but may be required to hire external, IIFF-funded M&E agencies to examine all aspects of the Project (Annex 5). IFC will track several financial, economic, and development indicators as discussed in Section II B above.

D. Sustainability

85. **The sustainability of the project's outcomes – in terms of stimulating the development of a long-term debt financing market for infrastructure and facilitating private infrastructure projects – will depend on two main sets of factors.** First, the project's sustainability depends on how well the IIFF performs its tasks. For the Government, the IIFF is its flagship intervention to get long-term financing for infrastructure projects. It is therefore highly committed to making it a success – and it has demonstrated this commitment during project preparation. The development partners involved in the establishment of the IIFF are also highly committed to its the success and are taking steps to work with the Government to put in place a management team for the IIFF that is committed to its sustainable operation. Secondly, the projects sustainability will also depend on the demonstration effects of producing successful commercially viable infrastructure projects supported by the IIFF. If successful, these projects will help stimulate greater interest among private financiers/institutional investors to provide long-term funds for future projects at more competitive prices and reduce risk perceptions related to infrastructure investment. Their success will in turn, depend on how well they are designed, how transparently they are procured, and on the robustness of their E&S management plans, all of which are goals to which the Indonesian government is committed.

E. Critical Risks and Possible Controversial Aspects

86. The following important risks that need to be addressed to ensure that the project objectives are achieved have been identified along with appropriate risk mitigation measures:.

Risk Factors	Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
The risk of using an FIL as the lending instrument	Reviews by IEG (May 2006) and QAG (December 2006) have pointed to the unsatisfactory outcomes of past FILs.	S	Relevant lessons from IEG-identified risk factors and past experience with FILs in Indonesia have been factored into the design of the IIFF. The project complies with OP8.30.	M
Risk of poor coordination among develop-ment partners.	High transactions cost for the borrower could arise from the participation of several development partners.	S	The Bank Group will maintain its lead role through the project preparation- and implementation phases. As shareholders in the IIFF, the shareholders' agreement and governance structure of the IIFF will help coordinate development partner involvement and focus efforts on the needs of the IIFF.	M
Insufficient pipeline	There is the risk that even with the presence of the IIFF, GoI may not move quickly in enabling the creation of a sufficient number of viable infrastructure projects for the IIFF to finance.	H	Considerable progress on regulatory issues has been made in the last few years. The creation of a strong advisory capacity in the IIFF will enable it to participate in the development of bankable projects. As part of project preparation, extensive work has been done on the pipeline of projects and the identification of potential opportunities for the IIFF. Projections for the IIFF's growth are deliberately very conservative.	S
Financial risks	IIFF will face the credit, interest rate, and operational risks that financial institutions of a similar nature typically face. It could also face operational risks – such as through poor governance	S	IIFF will be taking on credit risks of infrastructure projects. Sound subproject selection procedures put in place at IIFF though the OM as well as high quality of its management will mitigate this risk. IIFF could face interest rate risks – the subordinated debt it obtains from the GoI (through SMI) will be linked to a floating rate (SBI) while its value added will come from providing fixed-rate funding to infrastructure projects. IIFF will leverage its strong balance sheet and raise long-term fixed rate funding from the domestic markets leveraging its equity capital and subordinated debt and interest rate risks will be lower on such market funding. Operational risks – such as through poor governance - are discussed below.	M

Risk Factors	Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
Governance and Corruption risks.	There is a risk of capture by political interests. Politicians may see the IIFF as an attractive vehicle to support particular interests or through which they can extract favors.	M	It is critical both for the establishment of the IIFF and its later growth that it is seen as commercially driven, making decisions on business merits alone. The controlling stake to be held initially by IFIs is one response to this concern. The international best practice governance arrangements being initiated up-front in the shareholder agreements and the GoI's commitment to allow fully commercial operations based upon internationally accepted standards also mitigate the risk considerably. A strong, technocratic management team, many of whose members are likely to be recruited internationally on performance-based contracts, is another important mitigating factor.	L
	There is a risk that IIFF as an unlisted private institution may have be less transparent than a listed company	M	The IIFF will voluntarily comply with the regulations prescribed by Bapepam-LK and the listing requirements of the IDX, particularly regulations regarding governance and transparency, even though the IIFF has not been listed in the IDX. These commitments will be incorporated in the IIFF Articles of Association and/or shareholder agreements.	L
	Integrity and transparency risks in project implementation arise from the differing procurement standards and competencies, and different levels of transparency followed by the various concessioning authorities that could be involved in the project, leading for example, to inconsistent treatment of bidders, inappropriate rejection of bidders, bid rigging, etc.	H	The IIFF will finance only those projects that comply with its internal policies and guidelines, articulated in the OM which is being developed in consultation with the IIFF shareholders and approval of which is condition of effectiveness of the Bank's loan. These requirements and the need to establish internal policies and guidelines will be stated in the IIFF's Articles of Association and/or Shareholders Agreements.	M
	The risk of unintentional involvement in corruption arises if a member of IIFF management or staff unintentionally and in good faith engages in an illegal practice because s/he do not understand what constitutes corruption	M	The IIFF will have an HR section in its Operations Manual – that will be approved by the Bank - with clear descriptions about what constitutes corruption, collusion and nepotism as defined by the World Bank's/IFC's guidelines and Indonesian Criminal Law. All IIFF management and staff will attend an induction session where they will read the relevant description of corruption and sign a statement that they understand it.	L
Social and environmental	The Bank Group faces possible reputational risk related to subproject environmental and social safeguard issues and due to a lack of	H	IIFF will have a common ESSF to identify, mitigate and monitor potential environmental and social impacts in compliance with Bank Policies and IFC PS, the GOI's applicable laws and regulations and in	M

Risk Factors	Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
safeguard risks	environmental and social capacity at the IIFF.		accordance with the recently approved "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC, and/or MIGA" (dated January 21, 2009). It will build the necessary capacity to undertake appropriate project appraisal, risk identification and mitigation measures per Bank Group guidelines. The Bank Group will monitor the IIFF's adherence to such guidelines through its ongoing project supervision.	
Reputational Risk to the Bank Group	The IIFF will be seen by many as the creation of the IFIs, led by the World Bank Group, in support of the Government's initiative. The failure of the proposed project either prior to or following its launch could reflect poorly on the WBG.	S	This risk can be mitigated by ensuring that sufficient resources from the Bank Group are committed to project implementation and supervision to assist in the success of an initiative in which the WBG has assumed such a prominent role.	M
Absence of private investors	The GoI and a group of IFIs will launch the IIFF. Particularly in the current global climate, it would be difficult to attract private investment prior to the launch of the IIFF.	M	Potentially interested parties are currently being sounded out, although this must remain tentative and informal before Board approval. These efforts will stepped-up immediately after Board approval and signature of the Shareholders' Agreement, with the aim of bringing one or more private investors on board within the first year. Pending their arrival, the identification of a CEO with a private sector background and a clear vision of the IIFF as a commercial enterprise may be the most important balance to this risk.	L
Exit risk for IFC	There are unlikely to be any guaranteed exit options upfront as there would likely be no single party able or willing to provide IFC with a put on its equity investment.	S	Getting this greenfield investment to a point where it will be a viable IPO proposition will take some time. The IIFF will likely benefit from an extended association with IFC and a long-term hold should be acceptable from a developmental standpoint. Also, whilst it will take time to build value, if it succeeds, the IIFF will have a unique and profitable market niche, that should make it an attractive investment for those who wish to come in as secondary purchasers. The Project Team will nsure that IIFF's founding documents contain provisions that facilitate a smooth exit.	M
Procurement	IIFF is not yet established and it is not possible to assess its capacity in managing the procurement under sub-loans. Potential recipients of sub-loans are not yet identified and it is not possible to assess	H	Specific actions that will be taken to mitigate this risk include: (i) Creation of a procurement department within IIFF that will have responsibilities to assess the procurement management systems of the entities in which IIFF will provide loans (ii) Recruitment of an	M

Risk Factors	Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
	their capacity to conduct competitive bidding processes.		internationally experienced consultant to assist/train IIFF procurement department (iii) Preparation of the procurement section of the operational manual for guidance for IIFF borrowers (iv) Training to be conducted for any sub-loan recipient on procedures for competitive bidding and (iv) IIFF to monitor procurement by borrowers.	
Financial Management Risks	IIFF has not been established yet. Thus it is not possible to assess the financial management capacity of the implementing entity and the capacity of managing the proposed sub loans. Potential recipients of the sub-loans have not been identified yet. It is not possible to assess their capacity in managing the sub loans.	H	Specific actions that will be taken to mitigate this risk include: (i) Creation of a strong FM department in IIFF and staff it with professionals with adequate experience (ii) Instituting a computerized accounting and financial reporting systems suitable to the needs of the organization (iii) Preparation of the financial management section of the operations manual which lays out the FM requirements for appraising sub-loans and all the policies, procedures and processes of financial management for the organization and (iv) Provision of training on financial management to IIFF staff.	S
Overall risk		H		M

F. Loan Conditions and Covenants

87. **It is important to highlight that IIFF can only be established after approvals of equity investments and loans of the Bank/IFC and other IFIs involved have been obtained.** In this situation, as is normal for project financing which relies on simultaneous conditions precedent being met across various sources of loan and equity financing, it is clear that there will be a set of effectiveness conditions prior to disbursement of the Bank's loan. The World Bank will enter into a Loan Agreement with the Republic of Indonesia and a Project Agreement with SMI and IIFF. The following are Conditions of Effectiveness:

- the Subsidiary Loan Agreement, acceptable to the Bank, shall have been duly executed and delivered on behalf of the Borrower and SMI and shall have become effective and binding upon such parties in accordance with their respective terms, subject only to the effectiveness of the Loan Agreement;
- the Subordinated Loan Agreement acceptable to the Bank, shall have been duly executed and delivered by or on behalf of SMI and the IIFF and shall have become effective and binding upon such parties in accordance with their respective terms, subject only to the effectiveness of this Loan Agreement;
- the IIFF shall have been legally incorporated pursuant to the Borrower's laws and regulations and the Articles of Association of the IIFF shall have been executed by the founding Shareholders and approved by MLHR.
- the Borrower, through the MOF, shall have issued the Business License to the IIFF;
- the Co-financing Agreement (ADB Loan Agreement) shall have been executed and delivered and all conditions precedent to its effectiveness or to the right of the Borrower to make withdrawals under it (other than the effectiveness of this Agreement) have been fulfilled;
- the Shareholders Agreement, and any related share subscription documents to be entered into by and among the founding Shareholders and/or between the IIFF and the founding Shareholders shall have been executed and delivered on behalf of the parties and shall have become effective and binding upon such parties in accordance with their respective terms;
- the Project Agreement, shall have been duly executed and delivered on behalf of SMI and the IIFF and shall have become effective and binding upon the SMI and the IIFF in accordance with their respective terms;
- the Operations Manual, including the ESSF, acceptable to the Borrower and the Bank, shall have been adopted by the IIFF;
- each founding Shareholder shall have subscribed and paid up its respective initial capital contribution in such amount as required by the Shareholders Agreement;
- SMI shall have made available and disbursed financing in an amount of not less than IDR 600 billion (equivalent to about USD60 million) (less the amount of the initial equity contribution of SMI as required under the Shareholders Agreement); and
- the IIFF shall have appointed and employed a chief executive officer, a chief financial officer and an environment and social safeguards staff acceptable to the Borrower and the Bank.

88. **In addition to standard terms and conditions, the Loan Agreement and Project Agreement will contain the following covenants:**

- Except as the Bank and the Borrower shall otherwise agree, the Borrower shall ensure that the IIFF shall not incur any subordinated debt (referring to the loans from the Bank and ADB), if after the incurrence of such subordinated debt the ratio of subordinated debt to equity shall be greater than 2.5 to 1.

- Additional suspension events include the failure of any of GoI, SMI or IIFF to perform their obligations under the Subsidiary Loan Agreement, the Subordinated Loan Agreement or the Shareholders Agreement; the failure if IIFF to maintain its business license, the amendment, suspension, abrogation, repeal or waiver of any of the GoI regulations that allow the establishment and operation of IIFF, the Subsidiary Loan Agreement, the Subordinated Loan Agreement, the Shareholders Agreement, the Articles of Association, the Business License or the Operations Manual so as to affect materially and adversely the carrying out of the Project.

- Each of PTSMI and the Company shall establish an integrated financial management system, including internal control systems and internal audit function with terms of reference satisfactory to the Bank and the Borrower, by the date which is no later than 120 days after the Effectiveness Date.

IV. APPRAISAL SUMMARY

A. Economic and Financial Analyses

Economic and financial analyses

89. **As noted earlier, the state of Indonesia's poor infrastructure is widely accepted as a major constraint to accelerating growth and reducing poverty.** The Government has set ambitious targets for increasing infrastructure investment to reduce the constraints to growth and continues to develop a framework for private financing of infrastructure where risks can be appropriately shifted to the private sector, recognizing the economic and financial efficiencies that can be generated.

90. **Economic analysis of sub-projects to be financed by IIFF can only be undertaken after IIFF is established and it identifies a set of projects that it would support.** The OM will lay out a methodology for economic assessment of sub-projects by IIFF. The economic analysis of the sub-projects will attempt to quantify their costs and benefits, and measure the net contribution of these sub-projects to society at large. As an example, for any toll-road projects that IIFF may finance, some of the key benefits that such sub-projects are designed to provide include accommodating higher levels of traffic, reducing travel time, and lowering vehicle operating costs. Specifically, the benefits measured by the economic analysis included savings in vehicle operating costs (VOC), and a reduction in vehicle travel time (VOT) due to improved road conditions that would result in improved riding quality and higher travel speeds. At the same time, these sub-projects also impose real costs, including construction costs, routine maintenance cost during construction period, and environmental and social costs. The Economic Internal Rate of Return (EIRR) and the Economic Net Present Value (ENPV) will be estimated by lifecycle costs and benefits to society under the 'With' and 'Without' project scenarios. The Bank team will monitor such analysis by IIFF and the performance of sub-projects during project supervision.

91. **One set of key economic benefits of the Project, not quantified in the analysis, is that it will help develop a market for long-term local currency infrastructure financing.** The Project aims to enable IIFF to act as a catalyst for mobilizing such financing. IIFF can also help set benchmark rates for long-term infrastructure financing through tapping the domestic and international markets for longer tenor debt financing. IIFF is also expected to engage in new product development (e.g., domestic and foreign currency denominated interest rate swaps, partial credit guarantees, etc.), which should also assist the development of a domestic market for long-term infrastructure bonds. For infrastructure projects for which IIFF provides advisory services, better structuring and bankability would provide a net economic benefit to society in terms of better quality infrastructure projects, over and above the benefits of IIFF financing.

92. **The key driver for IIFF's financial projections is the build-up of its assets, mainly its loan book.** This poses a problem in as much as IIFF's asset growth is difficult to estimate purely on a trend projection because it is IIFF's mission to break that trend and bring about growth in Indonesia's infrastructure development. Therefore, two assessments of the market were conducted: (i) a top-down review which resulted in the identification of a pipeline of US$76 billion up to 2015; and (ii) a bottom-up review of Indonesia's infrastructure projects pipeline whereby details of projects were analyzed, sector by sector. This produced a more specific projects pipeline of US$38 billion for the period 2009 – 2011. Based on conservative approach, IIFF market share is estimated below 2.5%.For the time horizon beyond 2011, the base case assumes an annual growth in infrastructure funding demand of 5 %.

Projected Balance Sheet

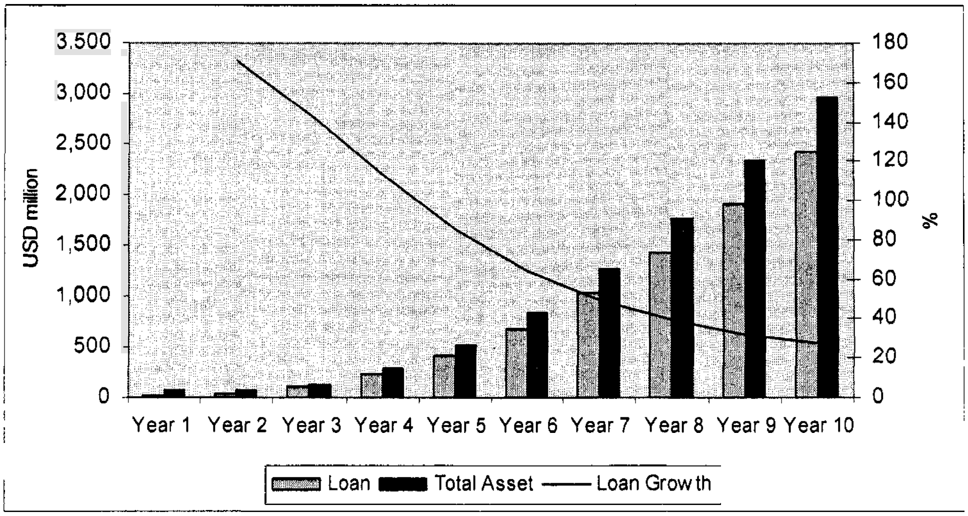
93. Table 6 summarizes the base case of IIFF's balance sheet projections:

Table 6: Summary of Balance Sheet Projections

in US$ million:	Year 1	Year 2	Year 3	Year 5	Year 7	Year 10
Cash + Securities	48	30	17	66	163	382
Net Loans	16	44	106	417	1,028	2,423
Equity Investments	-	-	5	24	58	126
Total Assets	67	77	131	516	1,268	2,972
Market Borrowings	-	-	-	107	704	2,057
Subord. Debt	-	0.8	31	200	200	200
Convert. Debt	57	53	45	17	-	-
Total Equity	10	24	50	142	221	332
Other Liabilities + Reserve	(0.6)	(1)	5	49	143	384
Total Liabilities +Equity	67	77	131	516	1,268	2,972
CAR I	40%	40%	40%	35%	27%	22%
Gearing	6.8x	2.6x	1.5x	1.9x	2.8x	3.7x
Gross Non-Performing Asset	0%	1.5%	2%	4%	3.5%	3%

94. **Loan and Equity Portfolio**: In the initial years, .IIFF may acquiring some existing loans from other banks, refinancing loans on a more appropriate long-term basis for infrastructure projects which are already in operations, particularly where this may free up cash flow for sponsors willing to commit cash flow savings from the refinancing to new infrastructure investment. IIFF may also generate additional fee-based income thru developing advisory business for both GoI and project developers in the first three years. It is projected that the loan book will grow from US$16 million in year 1 to reach US$ 106 million in year 3. In year 4 and onwards, it is projected that IIFF's loan portfolio will grow in line with the increased market demand and extend its total outstanding loans to US$2.4 billion in year 10. Investments in equity may be trailing the lending operations as IIFF staff will have to gain familiarity and expertise with Indonesia's infrastructure finance market before embarking on riskier equity investments. Figure 5 below shows the build-up of the projected loan portfolio and its growth (and total assets build-up).

Figure 5: Projected Asset and Loan Book Build-up
(in US$ million)



95. **Asset Growth**: In line with the increasing pipeline, IIFF assets is projected to almost double in year 3, and later steady grow at the range of 27 to 49% from year 7 onwards when the total assets are projected to reach US$ 2.97 billion at year 10.

96. **Asset Quality**: NPA are projected to be low in the first two years of operations due to IIFF conservative approach in secured lending, i.e. 85% of IIFF financing will be in the form of senior term loan. Starting in Year 3, IIFF will consider investing small part of its equity stake in projects. The rationale behind this is that infrastructure investments are lumpy and one bad loan/unsuccessful equity investment can cause the NPA ratio to spike; some unfavorable investment decisions cannot be excluded in the early years when the portfolio remains small although IIFF's important position in Indonesian infrastructure in its early years should allow it to be highly selective. It is recognized however that the infrastructure financing market will be a partly untested field.

97. **Equity/Leverage**: Starting with a seed capital of US$10 million as required by the Infrastructure Financing Company's regulation, IIFF 's total equity is projected to reach US$50 million in year 3 and US$142 million in year 5. As IIFF's asset base will grow, shareholders will continue to subscribe to new rights issues to support IIFF's growth and maintain a conservative capital structure. While the CAR I is projected to stay at 40% in the first three years, IIFF will steadily maintain its CAR position above 22% level. The projected gearing ratio (total debt/total net worth) will be relatively high in year 1 at 6.8x, but the gearing ratio will drop quickly as the loan book grows, equity rises, and the CAR I needs to be maintained at a conservative level. Most of the time, the gearing will hover at the range of 1.5 to 3.7x . The logic for that is that IIFF will be able to handle a higher gearing and lower CAR I after building sufficient experience and having created a track record for itself.

98. **Funding**: In its initial years, IIFF will have two strong funding tools at its disposal; US$ 200 million in subordinated loans from IBRD and ADB, and SMI's convertible debt. It is projected that the convertible debt will only be fully converted into equity by the end of year 6. The subordinated debt will gradually be drawn down as needed, and the full draw-down is projected for year 5. These three funding instruments will secure IIFF from raising external funding sources in its early years of operations when its risk profile is higher. Not only are these instruments attractively priced but they also allow IIFF to establish itself a name in the market before looking for third party funding. The savings from these two

funding sources are quite considerable and will ease any pressure on IIFF's funding side in the early operational phase.

Projected Income Statement

A summary of IIFF's projected income statement is shown in Table 7 below:

Table 7: Summary of Income Statement Projections

in US$ million:	Year 1	Year 2	Year 3	Year 5	Year 7	Year 10
Interest Income from Loans	1.01	5.12	13.12	56.95	151.90	383.17.
Total Interest Income	2.51	7.43	14.83	61.61	164.35	414.47
Net Interest Income	-0.48	1.88	7.71	27.85	64.74	140.89
Profit from Equity Sales	0	0	0	0	0	6.42
Income from Advisory Services	0.28	0.62	1.14	3.52	4.93	4.93
Operating Expenses	1.66	2.86	2.08	2.78	7.40	18.58
Profit before Taxes	-1.97	-0.90	5.82	27.85	62.11	133.84
Profit after Taxes	-1.97	-0.90	4.07	19.50	43.48	93.69
Net Interest Margin	-1.5%	2.7%	7.9%	7.5 %	6.5%	5.6%
RoA	-5.92%	-1.26%	3.92%	4.91%	4.11%	3.53%
RoE	-47.21%	-6.17%	11.25%	14.64%	14.52%	16.14%

99. **Interest Income**: While minimal in the first few years, interest income is projected to grow strongly in line with the increase in the loan portfolio. Interest income from loans will represent more than 90% of total interest income (except in the first two years). The net interest margin is weak in the first year as the loan portfolio remains small. As IIFF's capital is not fully directed towards lending, some of the capital will be invested in short-term instruments with lower rates in year 1. However, along with the growing of IIFF loan portfolio in year 2, the net interest margin reaches a comfortable 8.2% level in year 4. In year 5, the net interest margin decreases as a consequence of IIFF effort in raising more expensive funding from market to support the loan book growth.

100. **Advisory Fees**: Although advisory services will be a critical area of focus in the early years because of the need to help create an infrastructure pipeline, revenues generated from this activity are expected to be small as IIFF establishes its value in the market. Consulting for GoI entities may generate only limited revenues even though it may play an essential role in generating bankable projects. It is anticipated that some of the remuneration from GoI consulting could be paid through donor-supported programs. Because of this, advisory income will start at a low US$280,000 and increase to US$620,000 and US$1.14 million in year 2 and 3, respectively. Beyond year 3, it is assumed that IIFF has the capacity to obtain advisory contracts from private-sector developers that boosts its advisory income.

101. **Profitability**: Measured as RoA, profitability is strongly correlated with the level of the net interest margin. Profitability reaches its peak at 5.28% in year 4 and gradually steady at level above 3.5 % in the following year. Meanwhile, RoEs track RoAs with a multiplier of 2.9 – 3 x up to year 6, but as IIFF's gearing increases, the RoEs rise much stronger and reaches a 4.6x multiplier to RoA in year 10.

102. **The base case projects an IRR of 15.4%, which is 6.9% above the cost of IFC's equity.** This can be considered a fairly good outcome since a conservative base case is presented here to reflect some of the uncertainties in the market better. Apart from the base case, an up-case and a down-case scenario were also run to test the Project's resilience. Table 8 below summarizes the key variables which were adjusted for the sensitivity analysis:

Table 8: Sensitivity Analysis

Dimensions:	Base Case:	Up Case:	Down Case:
Growth of infrastructure demand	5% p.a.	8% p.a.	3% p.a.
NPA ratio	4% peak and decreasing to 3.0%	Starting at 1% and increasing to 3%	6% peak and decreasing to 4.8%
Annualized return on equity sold	10%	20%	7.5%
Advisory income	US$280K (year 1); US$620K (year 2); US$1.14 mn (year 3); then in line with demand growth	US$280K (year 1); US$840K (year 2); US$1.69 mn (year 3); then in line with demand growth	US$280K (year 1); US$420K (year 2); US$630K (year 3); then in line with demand growth
*Interest rates on loans**	- 1% on all loan rates	-.-	-1.5% on all loan rates
Loan portfolio growth	US$16 mn (year 1); US$44 mn (year 2); US$108 mn (year 3); then in line with demand growth	US$29.5 mn (year 1); US$97.9 mn (year 2); US$244 mn (year 3); then in line with demand growth	US$16 mn (year 1); US$39 mn (year 2); US$90 mn (year 3); US$167 mn (year 4); US$265 mn (year 5); then in line with demand growth
Risk Weighting of Loans	All 100%	Senior loans, refinance loans and take-out loans at 50%; rest of loans at 100%	All 100%

103. **The IRR of the three cases is as follows:**

Base Case = 15.4%

Up Case = 18.6%

Down Case = 13.3%

104. **IIFF's profitability is most sensitive to interest margin changes and then to asset growth.** However, the sensitivity analysis has shown that even under market conditions where demand for infrastructure financing and advisory services is not as strong as expected,

and therefore revenues will fall short of expectations, IIFF will be able to achieve an acceptable financial performance.

105. **The IIFF's profitability is most sensitive to interest margin changes and to asset growth**. However, the sensitivity analysis has shown that even under market conditions where demand for infrastructure financing and advisory services is not as strong as expected, and therefore revenues fall short of expectations, the IIFF will be able to achieve an acceptable financial performance.

B. Technical

106. **The project's technical design has benefited from an extensive body of analysis including Bank ESW and lending operations, the Government's medium-term and annual plan documents and IFC's experience establishing "green field" financial institutions.** The approach has also benefited from international experience with infrastructure financing institutions. Some of the key principles underlying the project's technical design include: (a) the critical role of the development of a long-term local currency debt market for the financing of infrastructure projects; and (b) the positive role that well-structured private infrastructure projects can play in increasing total investments in certain key sectors by using a limited amount of public resources to leverage a much larger amount of private investment. They can also help improve economic efficiency and lower the capital requirement for projects.

Key structural considerations for the new institution include a shareholding structure designed to accommodate private shareholders and to balance their interests with that of the Government and the IFIs in ensuring the long-term objectives of the IIFF are met. The IFC's experience has been particularly relevant in the establishment of key IIFF parameters in terms of its management framework, operational procedures, environmental and social standards, enforcement of high standards of integrity and transparency, and the management of potential conflicts of interest.

C. Financial Management

107. **The main financial management risks for the project at this time relate to whether SMI and the IIFF have sound financial management systems and suitable human resources[19].** SMI was established in February, 2009, and has yet to develop a financial management system. The IIFF had yet to be established at the time of this assessment. FM risk in SMI is likely to be lower than in the IIFF as SMI will act as the GoI's fund-channeling agency. The IIFF will manage and use these funds to provide a variety of financial products and services to commercially viable infrastructure projects. Further FM assessments will be conducted after the IIFF has been established.

108. **The financial management risks will be mitigated by:** i) the provision of technical assistance for the establishment of the SMI and the IIFF that is ongoing under donor funding and will be continued as necessary from SMI's and IIFF's own resources; ii) the provision of technical assistance to the IIFF for the recruitment of qualified staff — the IFC has provided grant financing for the retention of an executive search firm to headhunt the initial team, and it is expected that the IFC, ADB, and DEG will nominate one member each to the IIFF Board of Commissioners; iii) the provision of technical assistance to develop the

[19] A first draft of the financial management section of the operations manual has been prepared and submitted to the Bank. Further work in strengthening the OM and the proposed framework for the financial management department is being undertaken.

IIFF Operations Manual covering, among others, financial management and iv) adoption of the Operations Manual by the IIFF which is a condition for effectiveness of the Bank's loan.

109. **Overall, the project financial management risk is assessed as being high before mitigation, and substantial after mitigation.** This assessment has concluded that with the implementation of the action plan, the risks will be substantially mitigated. The proposed financial management arrangements will satisfy the Bank's minimum requirements under OP/BP10.02, and be adequate to provide, with reasonable assurance, accurate and timely information on the status of the grant as required by the Bank. More details of the financial management assessment are given in Annex 10.

D. Procurement

110. **IIFF is expected to invest in selected infrastructure projects under sub-loans to private sector firms and/or joint ventures of private firms and state owned enterprises.** Procurement for Works and Goods will be carried by the recipients of the sub-loans following the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004, revised October 1, 2006 (the Procurement Guidelines); and in particular para. 3.12 "Procurement in Loans to Financial Intermediaries". Procurement will be mainly done in accordance to established private sector or commercial practices acceptable to the Bank. The same principle applies to the selection of consultants under these loans whereby this will follow the Bank's "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004, revised October 1, 2006 (the Consultant Guidelines) and in particular para. 3.12 "Commercial Practices". Selection of Consultants will follow established private sector or commercial practices acceptable to the Bank. Due to the nature of the project, no prior review will be conducted by the Bank. IIFF will hire an independent private audit firm to conduct an annual audit which should cover technical, financial and procurement aspects of the sub-loans. The Bank will review and clear the TOR for this audit. The Bank will also retain the right under the loan agreement to conduct post reviews of contracts should it wish to do so. Annex 9 provides further details.

111. **At this stage, it is not possible to carry an assessment of the procurement capacity of neither IIFF nor any of the specific firms that may apply for sub-loans.** IIFF is still under establishment and there is still no specific pipeline for entities that will apply for funds. Accordingly the procurement risk for the proposed project is rated as *"High"*.

112. **To mitigate the procurement risks and to strengthen the project procurement implementation capacities, the following key actions are proposed for the project:**

- Create a procurement function within IIFF that will have responsibilities to assess the procurement management systems of the entities to which IIFF will provide loans. This department will also monitor the procurement of some of the major contracts which those entities enter into.
- Prepare a procurement section in the operational manual for guidance for IIFF staff and its borrowers.
- IIFF to recruit an internationally experienced consultant to assist/train IIFF procurement department staff.
- Training to be conducted by IIFF for any sub-loan recipient on procedures for competitive bidding

Risk	Rating Of risk	Mitigant	Rating Of residual risk
• *IIFF is not yet established and it is not possible to*	H	• Create a procurement function within IIFF that will have responsibilities to assess the	M

Risk	Rating Of risk	Mitigant	Rating Of residual risk
assess its capacity in managing the procurement under sub-loans • *Potential recipients of sub-loans are not yet identified and it is not possible to assess their capacity to conduct competitive bidding processes*		procurement management systems of the entities in which IIFF will provide loans • Prepare a procurement section in the operational manual for guidance for IIFF borrowers. • IIFF to monitor procurement by borrowers • Training to be conducted for any sub-loan recipient on procedures for competitive bidding • recruit an internationally experienced consultant to assist/train IIFF procurement department	

E. Social and Environment

Social Aspects

113. **The IIFF forms part of the overall development priorities of the Government aimed at supporting growth and poverty reduction by addressing a key constraint on the country's economy growth – inadequate infrastructure.** Projects supported by the IIFF are expected to have primarily positive social impacts. The IIFF is intended and expected to lead to increased infrastructure investment and delivery of infrastructure services over the medium-long term. In general, the poverty and social impacts of increased infrastructure investment will be positive, through the benefits of induced economic growth, and through the direct provision of infrastructure services.

114. **International experience indicates strong direct linkages between infrastructure service provision and poverty reduction.** Reliable, affordable and cost-effective provision of infrastructure services can help in improving health and education outcomes (reducing levels of child mortality from waterborne diseases, respiratory illnesses, better access to schools and clinics) and indirectly in reducing the fiscal burden of governments to create space for other expenditures. Indonesian experience matches this international pattern. A recent Bank report *Making the New Indonesia Work for the Poor* suggests that better access to roads and telecommunications "are associated with significantly lower poverty." Better quality also improves the pro-poor impact of infrastructure.

115. **There could, however, be potentially negative social impacts associated with the IIFF, and these will need to be managed and monitored.** For example, increased usage of roads financed by IIFF could lead to increased traffic accidents; social dislocation could occur as a result of land acquisition and involuntary resettlement in projects that IIFF supports; there is a potential for price increases for electricity and water services that are provided by private firms financed by IIFF. While the process of construction of infrastructure will yield short-term employment benefits, the full costs and benefits are only realized when construction of new infrastructure is completed. The negative externalities of expanded infrastructure, such as pollution and traffic accidents, often fall disproportionately on the poor.

116. **Both policy and project specific mechanisms to assess and manage these adverse consequences are necessary.** At a policy level, the Bank (and other development partners) is supporting reforms through its ongoing IDPL loan series aimed at mitigating some of these adverse impacts. Recent years have seen increased efforts by the police to improve reporting of accidents; increased efforts by various cities to improve public transport, which may contribute to the reduction of road accidents (about 60% of them involve

motorcyclists); and World Bank road projects included measures to promote improved design standards, helping to reduce the cause of accidents. The Bank is engaging with the Government through the Land Working Group to address issues associated with land acquisition, including social dislocation and inadequate compensation. The recent history of Indonesia's treatment of fuel price increases suggests a capacity to balance the negative impacts of price increases against other social benefits through democratic processes, and to introduce compensation where appropriate

117. **At a project level, IIFF's Operations Manual** will contain procedures to ensure that the environmental and social impacts of the sub-projects that it finances are assessed, managed and monitored in accordance with the requirements of Bank Policies and IFC's Performance Standards for Social and Environmental Sustainability. IIFF will build up its institutional capacity to ensure that it is able to implement the Operations Manual effectively.

Environmental Aspects

118. **Successful implementation of the IIFF project is likely to lead to increased and improved infrastructure services, with both positive and negative environmental consequences.** Some types of infrastructure investment will have positive environmental and health outcomes (e.g., water and sanitation facilities and better solid waste management). Increased provision of electricity through IIFF's financing of thermal power plants may be accompanied by adverse impacts on the environment, such as higher air emissions that may worsen the local ambient air quality and increased rates of greenhouse gas (GHG) emissions that may contribute to global warming. In the case of hydropower subprojects however, there would be environmental benefits such as avoidance of air pollutant emissions. Construction of new roads may increase access to fragile habitats, such as natural forests and coastal areas, contributing to their degradation.

119. **Both policy and project specific mechanisms to assess, manage and monitor these adverse consequences are essential.** From a policy perspective, the Government is taking specific actions, such as encouraging the connection of natural gas pipelines to existing combined cycle gas turbine power plants, which will reduce greenhouse gas emissions by permitting substitution away from current diesel fuel; and strengthening environmental standards for national roads projects by the Ministry of Public Works. The Bank (and other development partners) is supporting Government efforts in addressing some of these issues.

120. **At a project level, as mentioned above, IIFF's Operations Manual** will contain detailed procedures to ensure that the potential environmental and social impacts of subprojects financed by IIFF are adequately assessed, managed and monitored over the life of the investment in a manner that conforms to the requirements of Bank Policies and with IFC's Performance Standards for Social and Environmental Sustainability. IIFF will build up its institutional capacity to ensure that it is able to implement the Operations Manual effectively, and Bank group staff will provide ongoing guidance to IIFF staff to ensure that the Operations Manual is effectively and consistently implemented.

F. Safeguard policies

F. Safeguard Policies

121. **The IIFF will be established as a non-bank financial institution that will provide a variety of financial products and services to support commercially viable infrastructure subprojects.** Sponsors of such subprojects will approach IIFF for financing or advisory services, and IIFF will make the decision on whether to support a subproject based on its commercial viability, and according to the procedures set out in the Operations Manual that will be agreed prior to Project effectiveness among IIFF, the Bank, IFC, ADB and IIFF's

shareholders. IIFF will consider the potential environmental and social impacts and risks of any subproject that it finances.

122. **IIFF can be established as an institution only after all government approvals have been obtained and all initial shareholders and initial multi-lateral lenders have made their financing available.** As mentioned earlier, the Government and the ADB have obtained the necessary approvals for their respective equity holdings in IIFF. ADB has obtained approval for its $100 million loan that will be on-lent by GoI to IIFF. Subject to Board approval of the Bank's loan and IFC's equity investment, IIFF is expected to be formally established around October 2009. The Bank's loan will not become effective until IIFF management has been hired and a Social and Environmental Unit has been established. Given that this new institution will take some time to establish itself and consider and approve proposals from subproject sponsors, disbursement of Bank funds is not expected prior to May 2010.

123. **IIFF is expected to finance infrastructure subprojects in several sectors such as** energy, including power generation, transmission and distribution; water and sanitation; transportation, including roads, rail, ports and airports; industrial and commercial infrastructure; and telecommunications. As discussed in Section E above, it is very likely that many of the subprojects financed by the IIFF will have moderate to significant short-and/or long-term environmental and social impacts. However, the scale and location of impacts can only be identified at the time that IIFF screens subproject proposals. Impact minimization and mitigation measures will have to be prepared by clients of IIFF and approved and monitored by the IIFF based on an Environmental and Social Safeguards Framework (ESSF), which will be an integral part of the Operations Manual (OM) to be adopted by IIFF prior to effectiveness of the Bank's loan and IFC's investments.

124. **IIFF complies with OP 8.30 for financial intermediary (FI) lending.** The environmental assessment category of the Project is "FI". The Bank's safeguard policies that may be triggered by subprojects that IIFF is likely to finance include OP 4.01 (Environmental Assessment), OP 4.04 (Natural Habitats), OP 4.11 (Physical Cultural Resources), OP 4.12 (Involuntary Resettlement), OP 4.10 (Indigenous Peoples), OP 4.36 (Forestry), and OP. 37 (Safety of Dams). As IIFF will not finance irrigation or agriculture projects, OP 4.09 (Pest Management) is not triggered. As an FI operation, an environmental and social safeguards framework (ESSF) and management system (ESMS) approach is being followed to comply with applicable WBG Policies and IFC Performance Standards on Environmental Social Sustainability (IFC PS).

125. **Being a joint IFC/Bank operation and involving several other development partners,** the project is supporting a common ESSF to identify, mitigate and monitor potential environmental and social impacts in compliance with Bank Policies and IFC PS, the GOI's applicable laws and regulations and in accordance with the recently approved "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC, and/or MIGA" (dated January 21, 2009). This common ESSF will be applied by the IIFF in the selection and supervision of its infrastructure investments irrespective of the source of financing – ADB, DEG, IBRD, IFC, GOI, funds raised from the market, etc. This approach of a common ESSF has already been endorsed by ADB and DEG, and will be agreed to by all development partners and adopted by IIFF prior to effectiveness of the Bank's loan.

126. **The current draft ESSF builds upon the ADB-approved Safeguards Planning Document** and outlines (1) the types of subproject investments and the stages at which IIFF may invest (subprojects not yet prepared, subprojects ready for bidding, subprojects under implementation and fee-based advisory services); (2) requirements to comply with the policies that will apply to subprojects supported by IIFF and (3) implementation arrangements (screening, plan preparation, consultation, disclosure and monitoring), organizational

structure, and IIFF staffing that will be put in place to ensure that these requirements are implemented successfully and that subprojects meet all applicable requirements of the World Bank Group as well as Indonesian laws and regulations.

127. **The environmental and social policies adopted in the ESSF** have been discussed among the key project stakeholders, including IFC, the Bank, ADB, the Borrower (Directorate General of State Assets) and the Borrower's shareholder (SMI). It has been agreed that IIFF will have one common ESSF that complies with the environmental and social safeguards policies of all of IIFF's strategic investors. The ADB-approved Safeguards Planning Document, which is consistent with the ESSF, has been disclosed on ADB's and MoF's websites. The MoF has also disclosed on its website: (1) its discussion with IFC that IIFF's ESSF will conform to IFC's PS; (2) IFC's PS; and (3) the draft ESSF (in English and Bahasa Indonesia). The final version of the ESSF – acceptable to the Bank - will be the basis for the environmental and social sections of the OM. Since IIFF will be implementing the ESSF and the OM, it will be appropriate for IIFF, once established, to disclose the ESSF as the framework that it will follow. It should also be noted that IIFF itself needs to hold, as required under WBG policies, ongoing consultations and disclosures regarding the subprojects that it finances. Disclosures will be made in the local language as required.

128. **The consultations and disclosure carried out to date are considered appropriate,** given the fact that IIFF has not yet been established and, as a result, there is no management team in place yet that could adopt and disclose the ESSF as IIFF's own framework. It is also important to note that the subprojects to be financed have not yet been identified and the OM has not yet been developed. For these reasons, and the need to have IIFF's management in place to discuss its role in implementing the ESSF, no consultations with civil society have been held thus far. As the ESSF is an evolving document, additional consultations on the revised drafts of the ESSF will be carried out with a wider range of stakeholders, including civil society. The Borrower – and IIFF after it is established – will continue to carry out consultations and disclosure activities as the ESSF is updated. During project implementation, subproject specific safeguards instruments will be subject to consultations and disclosure as required by Bank Policies.

129. **The draft ESSF will continue to be updated to the satisfaction of the Bank Group and included as an integral part of the OM.** Completion of the OM, acceptable to Bank Group staff, will be a condition of effectiveness. The Bank's EAP Safeguards Secretariat will review the final ESSF and the OM, and its approval will be the basis for acceptability of the OM to the Bank. The Bank will not finance any investment until it has assured itself that IIFF has adequate capacity for ensuring that its subprojects are carried out in accordance with the ESSF and OM that are fully compliant with Bank Policies and IFC's PS.

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment (OP/BP/GP 4.01)	[x]	[ ]
Natural Habitats (OP/BP 4.04)	[x]	[ ]
Pest Management (OP 4.09)	[]	[x]
Cultural Property (OPN 11.03, being revised as OP 4.11)	[x]	[ ]
Involuntary Resettlement (OP/BP 4.12)	[x]	[ ]
Indigenous Peoples (OP 4.10)	[x]	[ ]
Forests (OP/BP 4.36)	[x]	[ ]
Safety of Dams (OP/BP 4.37)	[x]	[]
Projects in Disputed Areas (OP/BP/GP 7.60)	[]	[x]
Projects on International Waterways (OP/BP/GP 7.50)	[]	[x]

G. Main Features of the Proposed IFC investment

130. **IFC will invest up to US$40.0 million equivalent in common shares of IIFF.** At initial subscription, IFC will invest up to about US$2.0 million equivalent as its 19.9% share of IIFF's minimum regulatory capital. Through subsequent subscriptions and by participating in IIFF's rights issues (at IFC's discretion), IFC may increase its investment in IIFF to US$40 million equivalent, but will always have a shareholding no greater than 19.9%.

131. **To accommodate private-sector investors, each of the IFIs', including IFC's, shareholding may be diluted.** The IFIs, including IFC, will however retain a minimum shareholding of 5% each in the first five years of IIFF's operations to provide some measure of stability at the ownership level and to remain available to assist IIFF in its first years of operations.

132. **There is a risk that the business volumes may not grow sufficiently to justify the capital to be increased to US$200 million in 5 years as required by regulations.** In this event, IIFF will need to seek a waiver of this requirement, provision for which is contained in the regulations.

Annex 1: Recent Macroeconomic Developments

A. Indonesia in 2009

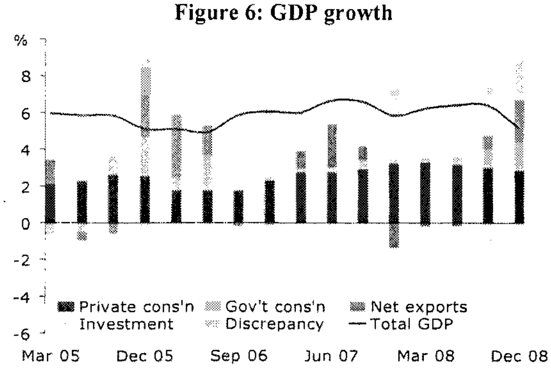
1. **Indonesia has made remarkable progress over the last decade in terms of macroeconomic and political stability.** Macroeconomic performance since the late 1990's has seen consistent output growth and rapid decline in external imbalances. Increasing tax revenues have contributed to the decline in the fiscal deficit. Increased growth has been grounded on increasing private sector investments and sustained domestic consumption. Under a scenario of controlled inflation and moderate interest rates Indonesian citizens managed to improve their living standards and reduce poverty levels. In addition, as the result of a sustained decade of relatively successful political and institutional reforms, Indonesia in 2009 is a highly competitive, decentralized electoral democracy. Governments at national, provincial, district and city level are elected in free and fair contests, with an incumbent loss rate of about 40 percent (one of the highest of any competitive democracy). A system of checks and balances between legislative, judicial, and executive branches is increasingly in place, with no one branch of government able to dominate, and few institutional outcomes 'guaranteed'. Where power was once radically concentrated around the presidency, it is now shared with the legislature and where power was once concentrated in Jakarta, it is now shared among 500 odd city, district and provincial governments.

2. **Although strongly affected by the current economic downturn, growth in Indonesia is expected to hold up relative well.** Growth remained near decade-highs up to the third quarter of 2008, before slowing sharply in the forth quarter with the worsening external environment and anticipatory retrenchment in domestic demand. Despite that, public finances remained in good health, with the budget barely in deficit in 2008 (-0.1 percent of GDP) and public debt ratios continuing their secular decline. With a strong fiscal position, Indonesia should be able to cushion the adverse effects of the global crisis on vulnerable groups, and provide additional resources for development priorities. In the period 2010-14, the budget is expected to increase by more than 30 percent in real terms when compared to the 2005-2009 period (about US$500 billion in 2008 prices) creating significant opportunities to improve public services. But in order to seize these opportunities Indonesia will need more effective and accountable institutions that can translate available resources into better development outcomes. This will be particularly important as Indonesia embarks on a period of *second generation reforms* to provide, for example, more sophisticated services in infrastructure, better education, and a sustainable health system.

B. The State of the Indonesian Economy Entering Mid-2009

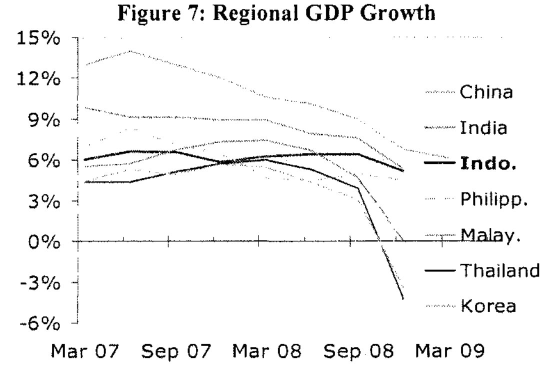
3. **Indonesia's slowdown has come relatively later and, so far, has been more moderate than for many countries.** GDP growth in the fourth quarter slowed to 5.2 percent y-o-y from 6.4 percent in the year to the third quarter. (Figure 6) For 2008 as a whole the Indonesian economy expanded by 6.1 percent, only slightly below 2007's 6.3 percent pace. Indonesia's growth held up longer, and the slowdown at the end of the year, while sharper than generally expected, was less dramatic than elsewhere in the region. (Figure 7). Nevertheless, the slowdown late in the year was broad-based as private consumption, exports and investment all declined, with only weaker imports and expanding government spending providing some offset. A notable outlier was the increase in agricultural production of 4.8 percent, the highest growth since 1992. While agriculture now accounts for 14.4 percent of total output, it continues to provide most or all of the income for 42 percent of households and solid growth prospects in that sector appear to be feeding into broader economic confidence.

Figure 6: GDP growth



Sources: BPS via CEIC and World Bank

Figure 7: Regional GDP Growth



Sources: National statistical agencies, CEIC and World Bank

4. **After several years of strong and sustained growth, lifted by rising commodity prices, the global downturn hit Indonesia's trade flows in late 2008.** Indonesia's total exports reached USD 136 billion in 2008, 20 percent above 2007's exports. But, the fall in commodity prices and, to a lesser extent, the compression in global demand had the anticipated impact on exports in the last quarter of 2008. This peaked in January, when exports fell the most in a decade. The dramatic decline in oil prices and associated falls in other commodity prices drove much of this decline in value. Real exports (in the GDP a measure of volume) were only 1.8 percent above the value of a year earlier in the fourth quarter and were down 5.5 percent over the third quarter, and container volumes were down especially in January although there has since been some recovery. By March there were incipient signs of a recovery, due to both the recovery in some commodity prices and in demand volumes for some items, with export values up 20 percent on February but still down 21 percent on a year earlier. Imports are closely linked to exports and have been falling rapidly as well: values were down 25.6 percent in the forth quarter over Q3 and 11.7 percent lower in GDP (volume) terms. These falls have been concentrated in intermediate and consumptions imports, down 45 percent and 27 percent respectively (y-o-y); more large transport equipment imports led capital import values 13 percent higher in March than a year earlier. The net effect of these falls was some compression of Indonesia's merchandise trade surplus which declined from USD 5.8 bn in Q3 to USD 4.6 bn in Q4. This surplus recovered somewhat in early 2009 as the falls in import values have been even more dramatic than those in exports.

Figure 8: Export values
(year-on-year percentage change)

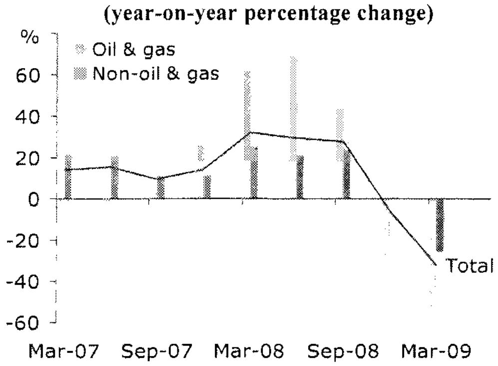
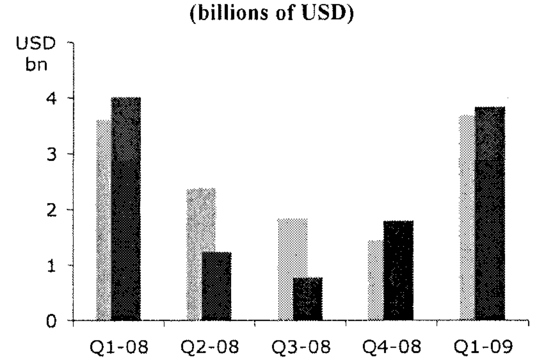


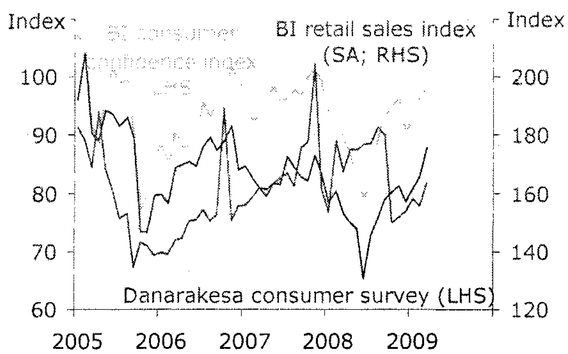
Figure 9: Trade balance
(billions of USD)



Sources: BPS and World Bank.

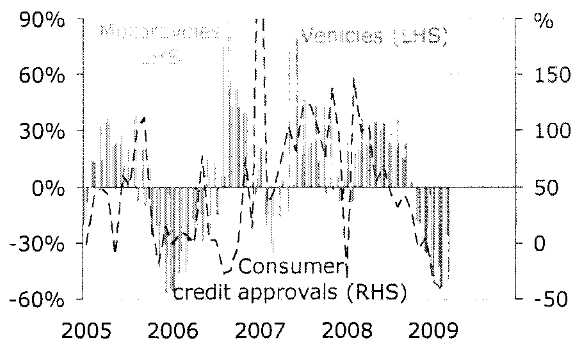
5. **With lower global commodity prices cutting profits and weakening demand firms are reducing investment.** As noted above, consumption and investment growth both slowed in late 2008 with fourth quarter investment up 9.1 percent y-o-y and construction activity up 5.7 percent, faster than aggregate demand but the slowest rate since 2002. This is evident in a small fall in industrial production (down 2.4 percent in the year to February 2009), and falling demand for cement and industrial use of electricity. Consumer confidence has been lifted by the pause in price growth (discussed below), and recent retail sales indicators have picked up too (seasonally adjusted). (Figure 10) Demand for consumer durables, notably motorcycles and motor vehicles, dipped in the fourth quarter and continued to fall into January before rebounding slightly in February and March, when car sales were down 27 percent and motorcycles down 11 percent over March 2008. (Figure 11)

Figure 10: Consumer confidence



Sources: BI and Danarakesa via CEIC, and World Bank. World Bank experimental seasonal adjustment.

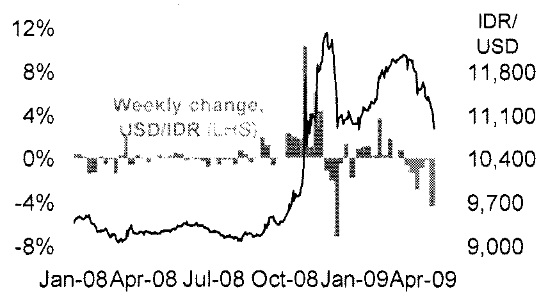
Figure 11: Demand for consumer durables (year-on-year percentage change)



Sources: Astra via CEIC and World Bank

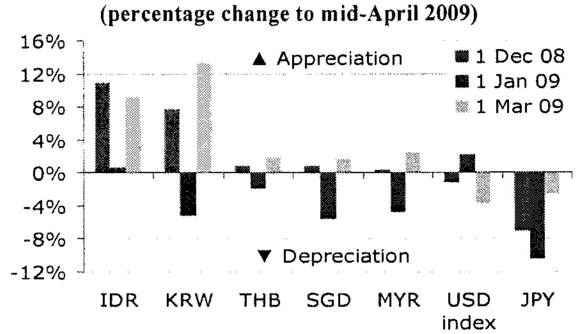
6. **Indonesian financial markets have followed the ups and downs of recent global trends.** After being severely affected in October and early November, they strengthened with renewed global confidence from late November, before weakening again in mid-January as market participants' perceptions of the global situation deteriorated. Most recently Indonesian markets have strengthened again in response to policy developments in the major economies, declining global risk averseness, and Indonesian moves to shore up financing including the contingent financing for the budget from development partners. After settling around 11,000 per USD in December, the rupiah depreciated gradually to well over 12,000, before recovering again to below 10,500 by early-May. (Figure12) Developments in the rupiah reflect both movements in global currency markets and Indonesia-specific factors. Since December 2008 increasing confidence in the country's policy response to the crisis, and in the sustainability of its financing needs, have led to one of the largest appreciations against the USD in the region. (Figure Figure 13) April's orderly parliamentary elections, and the government's early financing of its budget, further supported market confidence.

Figure 12: IDR vs. USD Exchange rate (IDR per USD and weekly percentage change)



Sources: BI via CEIC, and World Bank

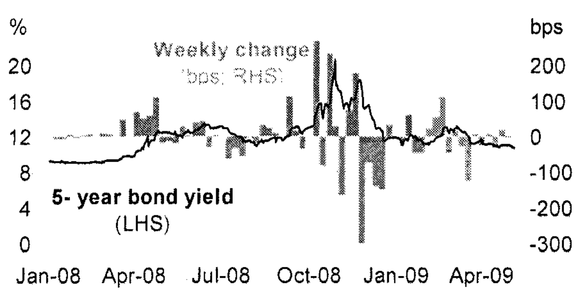
Figure 13: Regional exchange rates (percentage change to mid-April 2009)



Sources: FRB via CEIC and World Bank

7. **Yields on Indonesian government bonds, which were especially affected by the global instability, have recovered most of their losses.** By the end of 2008 Indonesian government bond yields had recovered much of their October and November losses (when, for example, the five year bond yield rose to over 20 percent), but were still at relatively elevated levels. They then retreated again in line with renewed global risk aversion in the first quarter of 2009. As the government filled much of its financing needs early in the year (discussed below), and global risk aversion declined, Indonesian bond yields recovered further. Shorter-tenor bonds have recovered most, as the central bank cut the overnight policy rate and reduced the yields on short-term certificates; longer-dated bonds also benefited from the post-March reduction in risk averseness. The premium on Indonesian government bonds denominated in IDR relative to those denominated in USD narrowed drastically early in 2009. While the yields on USD bonds especially have since recovered somewhat, the premium still remains historically low at 500-600 bps. Non-residents have also recovered some confidence in Indonesian government bonds. They cut their holdings from IDR 107 tr or about 20 percent of the total stock at the end of August 2008 to a low of IDR 78.7 tr in mid-March, but, with the turn-around in global financial markets and especially with growing confidence in Indonesia, they became net purchasers, increasing their holdings to IDR 85.6 tr or 15.5 percent of the total by mid-April.

Figure 14: Indonesian domestic bond yields



Sources: BEI via CEIC, and World Bank

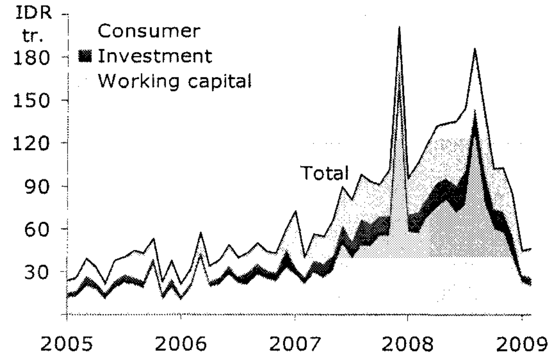
Figure15: Indonesian Global bond spreads

Sources: JP Morgan, BEI via CEIC, and World Bank

8. **Indonesia's bankers have strengthened their balance sheets in recent years and have little direct exposure to the financial sector stresses of US and European banks, but lending growth is slowing.** Fewer new loans are being approved, and anecdotal reports suggest that new customers, especially SMEs, are having difficulty accessing credit as bankers become more conservative towards consolidating their balance sheets. (Figure 16) At the same time

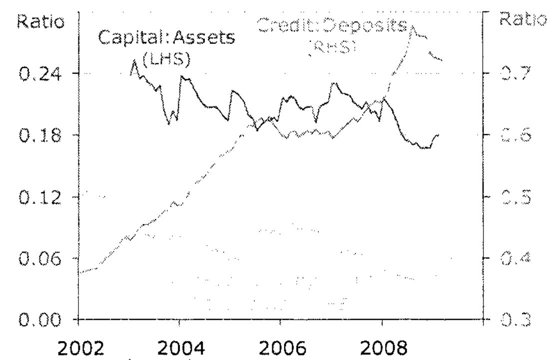
though, this slowdown in lending is only in contrast with the rapid lending growth of the first half of 2008, and demand for credit is also slowing, as firms reduce their working capital, or lower commodity prices cut financing needs, leaving credit lines undisbursed. While interbank lending has been improving since November and there is sufficient overall rupiah liquidity in the system, reports suggest that it is not well distributed with larger banks typically liquid and smaller banks facing problems. Other banking sector indicators continue to suggest the sector remains in relatively good health overall, with banks lifting their capital-to-assets ratio and only a marginal increase in non-performing loans at the start of 2009. (Figure 17)

Figure16: Credit approvals (seasonally adjusted, trillions of IDR)



Sources: BI via CEIC, and World Bank

Figure17: Banking indicators



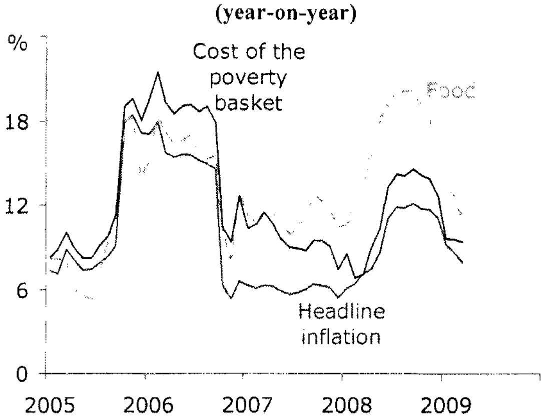
Sources: BI via CEIC, and World Bank

9. **Inflation has slowed sharply with the fall in commodity prices.** Reductions in international prices are passing into domestic and regulated prices (as fuel prices have been adjusted downward). Consumer prices have stabilized: they were unchanged between November and April, reducing the year-on-year inflation rate to 7.3 percent from a peak of over 12 percent in September. (Figure 18) This is despite the rupiah's 25 percent deprecation over this period. The inflation rate has fallen even more for poorer households whose consumption basket has a greater weight in food. Consumer inflation expectations are now at their lowest level since early 2005, when actual inflation was running close to 5 percent. Upstream prices have been falling since mid-2008: by February 2009 they were down 8 percent from their July 2008 peak, largely due to lower global energy prices and despite the depreciation in the rupiah.

10. **Indonesia's external position remains sound, though weaker than 2007.** Developments in global commodity and financial markets buffeted Indonesia's balance of payments throughout 2008. The current account ended in a small surplus of USD 0.6 bn, despite the bubble in oil prices in the first half of the year, which inflated first Indonesia's fuel import bill and then its net income deficit as oil producers transferred their profits abroad. Portfolio outflows at the end of 2008 moved the overall balance of payments into a deficit of USD 1.9 billion for the whole year, the first annual deficit since 2001. (Figure 19) The year-end portfolio outflows were driven by both residents, who shifted USD 2.7 bn into offshore bank accounts, and non-residents selling down their holdings of debt securities (net outflow of USD 3.8 bn from both corporate and government securities). Both the current account and capital flows were in surplus in the first quarter of 2009, according to preliminary estimates. Other areas of the capital accounts were relatively untouched by the turbulence on financial markets, and Indonesia recorded its largest

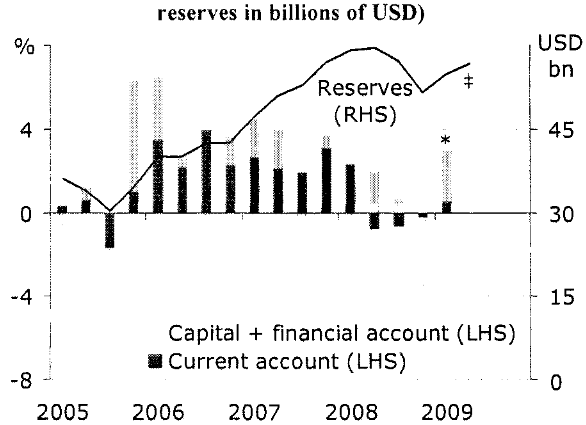
inflows of foreign direct investment since mid-2005 in the final quarter of 2008 and the first quarters of 2009 (based on preliminary data).[20]

Figure 18: Inflation (year-on-year)



Sources: BPS via CEIC, and World Bank

Figure 19: Capital outflows (balance of payments as percent of GDP; reserves in billions of USD)



*Notes and source: *Q1-09 data preliminary Ministry of Finance estimates. ‡ Q2 reserves data to April 30. BI, BPS via CEIC, MoF, and World Bank.*

11. **Indonesia's government is well-positioned to respond to the downturn.** In 2008 the budget deficit was just 0.1 percent of GDP, compared with 2.1 percent projected earlier in the year when international oil prices and Indonesia's energy subsidies peaked. Revenues were 9.6 percent above budgeted levels, due to high commodity prices and improvements in tax office administration, while under-spending continued as it has in recent years. Despite the exchange rate depreciation the debt to GDP ratio continued its secular decline, ending the year under 33 percent. The government also recorded a financing surplus of 1 percent of GDP, due to its lower-than-expected deficit and front-loaded borrowing strategy. In the first third of 2009, the central government disbursed 23 percent of its total budgeted expenditure, a slightly higher ratio than in 2008.

C. Policy-Makers' Response to the Deteriorating Global Economy and Indonesia's Economic Outlook

12. **Indonesia's monetary and fiscal policy makers responded quickly to the deteriorating global economy.** Bank Indonesia shifted monetary policy from the anti-inflationary stance of mid-2008, cutting interest rates by 225 bps to 7.25 percent between December and May 2009, their lowest level in four years. BI has also reduced the corridor between the interest rate banks receive on deposits at BI and pay on loans, and, during the peak period of financial market turbulence, injected liquidity into the inter-bank lending market.

[20] In addition to the USD 900 m investment by Qtel in Indostat in Q1-09, early May brought a surge of FDI announcements, including a USD 4.6 billion nickel project from France's Eramet and Mitsubishi of Japan; textile buyers from US, EU and Japan shifting USD 0.65 bn of orders from China; and Volkswagen, the German carmaker, announcing plans to open an assembly plant.

13. **The government is moving to shift fiscal policy to a more expansionary stance, including a 1.5 percent stimulus package.** In anticipation of declining revenues and the need for fiscal stimulus, Parliament approved an accelerated initial revision to the 2009 budget, with a 2.5 percent deficit target and 1.5 percent fiscal stimulus. (Figure 15) The revised budget seeks to stimulate demand by expanding government spending on infrastructure, and lowering taxes for specific sectors, in addition to the already-programmed reductions in tax revenues. Given difficulties in programming and lags in spending the government views tax cuts as the fastest and surest means of short-term stimulus, and their large share in Indonesia's stimulus package stands out from packages elsewhere.

Figure 20: National Budgets
(percent of GDP unless otherwise indicated)

	2006	2007		2008			2009	
	Actual	Budget	Realizat'n	Original budget	Revised budget	Prelim. Realiz'n	Initial budget	Revised budget
Revenues	**19.1%**	**19.1%**	**17.9%**	**17.7%**	**20.0%**	**20.7%**	**18.5%**	**15.5%**
Non-oil domestic tax	10.6%	12.0%	10.8%	12.2%	11.7%	20.4%	12.0%	11.0%
o/w Non-oil & gas income tax	5.0%	5.8%	4.9%	6.1%	5.6%	10.4%	5.6%	5.1%
o/w VAT	3.7%	4.3%	3.9%	4.3%	4.4%	5.3%	4.7%	4.3%
Oil & gas	6.0%	4.8%	4.3%	3.6%	5.3%	6.3%	4.1%	2.4%
Other	2.5%	2.3%	2.9%	1.9%	2.9%	-3.6%	1.8%	1.7%
Expenditures	**20.0%**	**20.2%**	**19.1%**	**19.4%**	**22.1%**	**19.9%**	**19.5%**	**18.0%**
Central Govt.	13.2%	13.4%	12.8%	13.1%	15.5%	14.0%	13.4%	12.5%
Personnel	2.2%	2.7%	2.3%	3.0%	2.8%	2.3%	2.6%	2.6%
Materials	1.4%	1.9%	1.4%	1.2%	1.5%	1.2%	1.7%	1.7%
Interest Payments	2.4%	2.3%	2.0%	2.1%	2.1%	1.8%	1.9%	2.0%
Subsidies	3.2%	2.7%	3.8%	2.2%	5.2%	4.5%	3.1%	2.3%
Social Assistance	1.2%	1.4%	1.3%	1.6%	1.3%	1.1%	1.5%	1.4%
Other Current	1.1%	0.5%	0.4%	0.7%	0.8%	0.6%	1.2%	1.0%
Capital	1.6%	1.9%	1.6%	2.4%	1.8%	1.5%	1.4%	1.3%
Transfers to Regions	6.8%	6.8%	6.4%	6.3%	6.5%	5.9%	6.0%	5.5%
Primary Balance	**1.5%**	**1.2%**	**0.8%**	**0.4%**	**0.0%**	**1.7%**	**0.9%**	**-0.5%**
Overall Balance	**-0.9%**	**-1.1%**	**-1.3%**	**-1.7%**	**-2.1%**	**-0.1%**	**-1.0%**	**-2.5%**
Assumptions/realized outcomes:								
GDP (IDR tr.)	3,338,196	3,779,155	3,957,404	4,306,608	4,484,372	4,954,029	5,327,538	5,487,578
GDP growth (%)	5.5%	6.3%	6.3%	6.8%	6.4%	6.1%	6.0%	4.5%
Inflation (%)	8.0%	6.5%	6.6%	6.0%	6.5%	9.8%	6.2%	6.0%
Exchange rate (USD)	9,141	9,300	9,419	9,100	9,100	9,694	9,400	11,000
Oil Price (USD/bl)	$64.00	$63.00	$78.00	$60.00	$95.00	$96.80	$80.00	$45.00

Sources: Ministry of Finance, BPS via CEIC and World Bank

14. **The global downturn, lower global commodity prices, and tighter global financing will continue to slow Indonesian growth in 2009 and 2010.** The sharp downturn in the global economy combined with the fall in commodity prices imply lower external demand and reduced incomes in exposed sectors and regions. Domestic demand is further slowed by tightening domestic credit conditions and greater uncertainty about the global outlook, which are reducing investment and purchases of consumer durables. Together these factors are expected to slow

growth to 3.4 percent in 2009, before the gradual recovery in the global economy in 2010 and commodity prices from late in 2009 pushes growth back into the 5 percent range next year. On the upside, the falls in commodity prices are likely to continue to limit inflation for some months yet. In the longer term, growth is expected to return to potential, which is based on population growth, recent investment rates, and Indonesia's improving institutional and investment environment. (Figure 21)

Figure 21: Indonesia's GDP growth projections

		Actual		Projected		
		2007	2008	2009	2010	2011
Domestic economy:						
Real GDP growth	%	**6.3**	**6.1**	**3.4**	**5.4**	**6.3**
Investment	% change	9.2	11.7	4.1	8.4	10.2
Consumer prices	% change	6.5	9.8	5.0	4.0	4.0
Budget deficit	% GDP	-1.3	-0.1	-2.0	-1.4	-1.2
Poverty rate	% pop'n	16.6	15.4	13.2	11.7	--
External sector:						
Current account balance	USD bn	**10.4**	**0.5**	**-0.1**	**-1.1**	**-3.7**
Exports GNFS	USD bn	131	154	113	124	140
Imports GNFS	USD bn	110	144	104	112	124
Growth environment:						
Trading parterner GDP	% change	1.9	3.0	-0.2	3.3	4.3
Real effective exchange rate	% change	5.7	9.4	-2.9	0.0	0.0
Export prices	% change	17.8	28.1	-39.8	-5.9	0.8
Credit growth	%	10.2	17.1	12.0	13.5	13.5
Gov't consump'n	% change	3.9	10.4	11.9	14.9	11.2

Sources: BPS via CEIC, and World Bank staff projections

15. **Considerable external financing requirements suggest some further net capital outflows are likely.** Scheduled debt repayments, bond amortizations, and projected current account movements in 2009 sum to a little over USD 30 bn. (Figure 22) In addition, non-residents may further reduce their holdings of ongoing Indonesian financial assets (eg, shares or bonds) or draw down their bank accounts. With very conservative assumptions, a scenario can be generated that fills at least half of these financing needs, and developments in the first quarter of 2009 suggest an even stronger outcome. While there does not appear to be a significant domestic trigger for strong capital account outflows, with currency swaps further reducing the risk of capital flight, there remains an ongoing, small, but important risk of large capital outflows, with residents remaining the largest source of outflow risk.

Figure 22: Financing needs in 2009
(billions of USD)

EXTERNAL FINANCING NEEDS, 2009	**30.4**
Current account deficit (-ve if surplus)	**.1**
Trade (GNFS) deficit (-ve if surplus)	-10.0
Net income	5.1
Maturing short-term FCU debt	**12.1**
Debt instruments	6.9
Trade credits	5.2
Short-term IDR liabilities to non-residents	**2.7**
Maturing short-term LCU debt	2.0
Amortization of medium and long-term IDR debt	.7
Amortization of medium and long-term debt	**15.6**
Public	7.0
Private	8.6

Sources: BI, BIS, and World Bank staff projections

16. **The crisis is expected to put pressure on poverty.** The poverty rate is expected to decline slightly by early 2009 to 15.0 percent from 15.4 percent in early 2008. This reflects overall economic growth in the 5 to 6 percent range, and especially strong results for agriculture, with slower growth in food and fuel prices, and especially the impact of the government's 2008-09 cash transfer program to poor and near-poor households (BLT). With a continued slowing in growth, and the BLT ceasing in March 2009, poverty is unlikely to fall much further by early 2010.

17. **Much uncertainty surrounds these projections, to both the down- and up-side.** A deeper than currently projected recession among Indonesia's trading partners, could bring some further declines in commodity prices and further depreciation of the rupiah, would lower Indonesia's 2009 and 2010 growth by an additional one-half of one percent to the 3 percent and 4½-to-5 percent range respectively. A longer recession, with slower trading partner growth in 2010, no recovery in commodity prices, and some additional depreciation in the real exchange rate, would slow 2010 growth by an additional three-quarters percentage point. But there are also upside possibilities, both domestic and external. For example, Indonesian policy makers could choose to expand the size of the fiscal stimulus package and adopt other measures to support domestic demand for example through improvements in the investment climate. The first months of 2009 have seen domestic demand and credit growth holding up better than most commentators expected. Plausible policy-driven movements in these domestic variables add about one-quarter of one percentage point to projected growth in 2009 and 2010. And global commodity prices in particular may recover faster and further than projected, which would also accelerate growth.

Annex 2: The Government's Infrastructure Agenda[21]

1. **Infrastructure policy constitutes a large part of the economic policy package (Inpres 5/2008) issued by the Coordinating Ministry of Economic Affairs in early 2008.** The policy package sets out key actions to be achieved during 2008 and 2009 in areas including national roads, railways, airports, ports, information and communications technology, flood control, water and sanitation, solid waste management, community-driven infrastructure programs, public-private partnerships, land acquisition processes, infrastructure financing, and subsidy (PSO) policy. It sets out objectives, deadlines, and responsible ministries. Compared to previous years' policy packages this package has a greater focus on outputs to be achieved (eg kilometers of roads to be built).

Electricity

2. **The Government has placed a high priority on encouraging investment in the electricity sector over the past two years.** Nevertheless, there is a long lead-time in contracting and construction, and it will be 2010 before substantial new capacity will be brought on line to address power shortages that have arisen from several previous years of inadequate investment. Moreover, with elections due in 2009 and much political capital used in reducing oil subsidies, the Government has been unwilling to increase electricity tariffs, hampering efforts to attract investment financing.

3. **With electricity demand growing at over 6% per year over the past decade, and very little system expansion during this period, the system now has an inadequate reserve margin.** Blackouts are occurring across the country. PLN has installed capacity of about 24,000 MW. Since early 2006, the Government has been pursuing a "crash" program to procure 10,000 MW of coal-fired power plants to be operated by PLN, the Government-owned utility. Around 3,600 MW of capacity are expected to be commissioned by the end of 2010, with the remainder of the crash program expected to be delivered by 2012. Simultaneously, PLN has pursued additional private investment in electricity, with IPPs expected to make an increasing contribution to capacity after 2012.

4. **The task of raising finance for the new investment is made very difficult by the fact that electricity tariffs have not been increased since 2003, when the average tariff was brought to the pre-crisis level of 6.8 cents/kWh.** Because of higher oil prices, and the significance of oil in PLN's fuel mix, the fuel cost alone now exceeds the average tariff. To ensure PLN's financial sustainability the Government provides a "Public Service Obligation" (PSO) subsidy, which covers the difference between PLN's costs and the regulated tariffs for different consumer categories.

5. **PLN's PSO amounted to more than US$4.2 billion in 2007.** Without efforts to cut demand, the impact of higher fuel prices is projected by PLN to increase the cost of the PSO to around US$10 billion in 2008 (2.5% of GDP). While the Government has political difficulties in increasing the regulated tariffs, PLN has been able to increase payments by residential consumers with the largest connection capacity (generally these are the wealthiest consumers), by restructuring the consumption levels at which particular tariffs apply. PLN has also engaged

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[21] This section is based on the Indonesia: Second Infrastructure Development Policy Loan (Report No. 46328-ID) document and ongoing preparatory work for the proposed Third Infrastructure Development Policy Loan.

in negotiations with large industrial and commercial consumers to increase payments in return for greater reliability in power availability. One factor which reduces the economic impact of PLN's load shedding is that many large industrial consumers have installed their own generators.

6. **One of the reasons for the current high cost of subsidies is reliance on expensive diesel to meet a significant proportion of base load, in addition to its normal role of satisfying peak demand.** Most of the currently planned capacity expansion is coal-fired power plants, which will result in significant reductions in the cost of meeting base load. The Government is also considering connecting natural gas to existing plants which currently burn diesel, and for developing geothermal power projects.

7. **The Government has recently reorganized PLN and appointed a new Board of Directors.** One of the changes is to re-establish a planning unit, which will improve the orderly development of investment projects and help the government forecast the fiscal burden of PLN's subsidies. The planning unit was fragmented in preparation for reforms that would have moved Indonesia to an unbundled competitive market. These reforms were disallowed by the Constitutional Court in 2004, disrupting the reform momentum: it remains the root cause of many of the sector's current problems. Another element of the recent restructuring is a move to regional business units. PLN's costs vary widely by region, and it is anticipated that this restructuring will facilitate the development of responses to region-specific problems.

Roads

8. **The first priority in any road network is maintenance of the existing network.** In 2006, the national road network of 34,628 km included 81% in good or fair condition, 10% in poor condition, and 9% in bad condition. The Ministry of Public Works' Directorate General of Highways aims to have no roads left in poor or bad condition by 2010, an objective which will be largely determined by budget availability. The Ministry of Public Works received a substantial budget increase in 2008. To provide a more systematic link between funding and sectoral performance targets, the Government is working towards a medium-term expenditure framework and performance-based budgeting. The Ministry of Public Works is keen to act as a pilot ministry for these initiatives.

9. **The development of an expressways network, including toll-roads is a national priority.** Development of an expressway network would provide an important boost to economic growth. The National Road Network Master Plan calls for the creation of 2,885 km of toll-road expressways, of which 676 km are already operational.

10. **The Government is seeking private investment to expand the toll-roads network.** The Indonesian Toll Road Authority, BPJT, was established in 2005 with regulatory powers and the responsibility to prepare projects for private investment. Concession agreements have been signed for 805 km in 22 sections of toll-roads. Fourteen of these agreements were signed prior to 1997, and because of difficulties in land acquisition have languished, unable to achieve financial close. Over the past two years, the Government has taken measures to address the land acquisition problems and to terminate projects that are still unable to achieve financial close. The Government has also tendered several new "batches" of toll-roads in recent years, and these are in various stages of preparation.

11. **Institutional capacity in the roads sector needs enhancement. Heavy vehicle overloading is prevalent, and road safety is poor.** Road works are often expensive and low quality, and collusion between contractors is a problem. The World Bank is assisting the

Ministry of Public Works and Ministry of Transport with a pilot road safety program, and pilot testing performance-based contracts for road maintenance, including vehicle loading control.

Piped Water

12. **Approximately 18% of the population, or about 40 million people, currently have access to piped water.** An extra 10 million household piped water connections would roughly double the number of people with access to piped water, and would cost in the order of US$1 billion. Merely providing connections is not sufficient, however. Additional investment is needed to ensure bulk water supply, and to improve water utility (PDAM) operations, to ensure that water is reliably available through the existing and any new connections.

13. **The Ministry of Public Works has ambitious national goals for expanding water access, but these goals can be contrasted with low levels of sectoral investment, the sub-national government responsibility for actually delivering water and sanitation services, and poor operational and management performance of PDAMs.** Sector investment has declined from an average of US$400 million in 1990s to under US$45 million in 2005, and is about one tenth of what is needed to achieve the 2015 Millennium Development Goals.

14. **In the absence of long-term local financing, donor support could provide the debt necessary to underpin new investments.** But not a single donor loan to the sector has been approved in the past decade. A significant obstacle to the flow of funds has been Ministry of Finance regulations that prevent donor financing to PDAMs which have debt arrears, or which are owned by local governments (PEMDA) that have debt arrears.

15. **This year marks the cutting of the Gordian knot of debt arrears of local governments (PEMDA) and their water utilities (PDAM).** A scheme has been developed for the rapid restructuring of debt arrears, which will remove current legal barriers to necessary financing. The new scheme will reschedule principal arrears and write off all penalties or interest arrears on PDAM and PEMDA debt, subject to a limited set of conditions, including submission of audited accounts, raising tariffs to cover basic costs, and in some cases a commitment to invest an amount corresponding to the amount of debt arrears being written off. In the event that a PDAM or PEMDA again falls into arrears, the new arrangements permit the Ministry of Finance to intercept fiscal transfers which would normally be made to the relevant PEMDA.

16. **Over the past year, BPPSPAM, a water sector advisory body, has assessed the managerial, technical, and financial performance of 306 out of 335 PDAMs, and published the results on its website.** Using criteria such as operating ratio, debt-equity ratio, customer structure, number of employees per 1000 customers, water losses and operating hours, the PDAMs have been classified into three categories: (i) healthy – 79 (26%); (ii) less healthy – 114 (37%), and sick – 113 (37%). The mapping will be updated every year to exert pressure on PDAMs to improve performance.

17. **Following on from the Water Resources Law 7/2004 and Government Regulation 16/2005 on Water Supply, which eliminated the need for local parliamentary approval of water tariff increases, Regulation 23/2006 on drinking water tariff policy was issued by the Ministry of Home Affairs.** This regulation introduced the principle of cost recovery and reduced the number of customer categories. Most PDAMs classified as healthy have benefited from tariff increases. Based on BPPSPAM's ranking, the Ministry of Public Works has sent letters to about 50 large PDAMs in the lower categories to adjust their tariffs to reach a cost recovery level of Rp. 3,500 per cubic meter.

18. **The Ministry of Public Works is providing technical assistance to PDAMs categorized as unhealthy (ie less healthy and sick), to assess their performance and draw up business plans.** Business plans are also required as part of the debt restructuring process. As part of the investments identified in the budget plans, the Ministry also provides capital improvements in the headwork, intake or treatment facilities, while PDAMs fund improvements in the distribution systems.

19. **Finally, the Government is examining ways to provide positive incentives to sub-national governments to improve the delivery of water and sanitation services.** Conditional fiscal transfers are being considered by the Ministry of Finance. Consultants have been mobilized using Dutch trust funds, and are working with the Ministry of Finance and Ministry of Public Works to develop the incentive scheme, as well as identifying other ways of encouraging financial flows into the sector.

Public-Private Partnerships

20. **The Government is pursuing PPP transactions in all infrastructure sectors, including toll roads, power plants, natural gas pipelines, rail, ports, bulk water plants, airports, and telecommunications projects.** Modest results are beginning to show. Some short sections of toll-roads and small bulk water treatment plants have commenced operation. Construction has commenced on over US$ 2 billion of new PPP projects, including power plants, toll-roads, and water treatment plants.

21. **Slow progress has generally been the result of poor project preparation, with inadequate background analysis undertaken prior to tendering, resulting in unrealistic expectations by tendering agencies.** Over the past year the Government has strengthened the project preparation process, and has placed greater reliance on external advisers. An electricity plant in central Java is being prepared with the assistance of an IFC advisory mandate. The ADB has mobilized a PPP project development facility, funded by a US$ 26.5 million loan, and a US$ 7.56 million grant provided by the Netherlands. The facility is currently providing support to 20 national and sub-national PPP projects, including toll-roads, ferry terminals, bulk water supply systems, railways, an airport, and a telecommunications project. The emphasis of current support is on improving the quality of feasibility studies prior to bidding.

22. **The Ministry of Finance may currently authorize guarantees or direct financial support only for PPPs which comply with Perpres 67, which requires three bids received in a competitive tendering process.** Given the infancy of Indonesia's PPP program, the requirement of three bids has proven to be a practical barrier to projects for which government support may be economically justified. Revisions to Perpres 67 are being considered which would authorize negotiations with successful bidders in cases where fewer than three bids are received. This would open the way for the provision of Government support to a wider range of transactions.

23. **The Government is also taking measures to address land acquisition issues which have blocked private toll-road development.** A revolving land fund was established by the Ministry of Public Works in January 2007. The fund finances land acquisition for toll-roads, and is reimbursed by the concessionaire when land acquisition is completed. The fund has been accessed by eight toll-road concessionaires, of which six have now commenced construction, and one toll-road section is already operational.

24. **Fourteen toll-road concession contracts were awarded prior to the financial crisis in 1997, and have not moved to financial close, in part because of escalation in the cost of land acquisition since initial contract award.** The Government has developed a "land-

capping" scheme, under which the concessionaires will pay 110% of the land costs initially envisaged, with the Government to pay for the remaining land acquisition costs. The Government funds available for this scheme are capped at Rp. 4.9 trillion. The criteria for allocation of these funds to particular concessionaires are described in the discussion of IDPL 2 triggers. Transactions that do not move to financial close after accessing the land-capping funds will be terminated.

25. **Finally, the Government is developing institutions to support infrastructure financing.** In addition to the proposed IIFF, a Guarantee Fund is being prepared to ensure the availability of government funds to honor guarantees given to private infrastructure projects. The amount of money available in the fund will cap the level of contingent liabilities the Government may assume. The World Bank is providing technical assistance in the development of the Guarantee Fund.

Land Acquisition

26. **Land acquisition is a frequent source of delays in infrastructure projects across all sectors.** A Land Working Group has been established to review issues associated with the process of land acquisition, with a view to removing impediments to timely land acquisition for infrastructure development. The Working Group is chaired by the President of the National Land Agency (BPN), and includes members drawn from the Coordinating Ministry of Economic Affairs, BAPPENAS, Ministry of Public Works, and the Ministry of Home Affairs.

27. **Two sub-committees have been established, dealing with "land banking" (in effect, the process of zoning land or purchasing land well in advance of potential projects) and "land acquisition".** The sub-committee on land acquisition has proceeded over the course of the year to identify the major practical issues encountered in land acquisition, and is preparing an action plan to address these issues.

28. **The World Bank is preparing trust-funded technical assistance that will go beyond the sub-committee's identification of issues, and assist in the design of pilot activities, such as a demonstration of revised approaches to land valuation.**

Managing Environmental Impacts

29. **The Government's annual work plan includes the environmental actions to be addressed in each budget cycle.** Some of the items mentioned include development of debt for nature swaps, reducing environmental pollution, reducing smoke and haze from forest and land fires, rehabilitation of forests and degraded lands, conservation of natural resources, improving environmental management through the spatial planning process, and developing environmental data and information. The Bank is supporting initiatives to improve solid waste management and to improve environmental impact assessment and management under the IDPLs.

30. **The Government recognizes the problems of solid waste (open dumping, open burning, and mismanagement) as an increasing pollution problem and a threat to public health.** Only about half of Indonesia's solid waste is actually collected, 15-20% is properly disposed, and less than 2% is treated (recycled or composted). About 85% of small cities and more than 50% of medium cities dispose of their waste in open dumps. The new Municipal Waste Management Law, enacted in early 2008, aims to reduce the generation of solid waste by encouraging communities to "reduce, reuse, recycle", and improve the handling of solid waste, through improved separation of types of waste and processing prior to final treatment.

31. **Indonesia has decentralized responsibility for environmental impact assessments, known in Indonesia as AMDAL.** All 33 provincial governments and 55% of kabupaten/kota governments have AMDAL agencies. The Ministry of Environment has undertaken two surveys of the quality of environmental assessments performed by these agencies. While quality is improving, the most recent survey still found that 21% of assessments were poor quality. The Ministry is undertaking measures to improve the quality of the work performed by these agencies, including through the licensing of AMDAL commissions, the certification of commission members and trainers, and the establishment of an AMDAL training center.

32. **The Government is also preparing revisions to the AMDAL law.** These revisions include sanctions for agencies that issue development permits without a necessary environmental impact assessment. The potential sanctions include revocation of the permit, and criminal prosecution of the responsible person. The revisions also aim to strengthen public consultation in the AMDAL process, providing for the possibility of representation of the public by technical experts.

Ministry of Public Works Governance Issues

33. **The Ministry of Public Works (MPW) accounts for a considerable part of the national government's public infrastructure investment program, including US$2 billion per year delivered through the Directorate General of Highways.** Measures to improve governance in MPW include improvements along the length of the project cycle from planning and design through payments and audit.

34. **Planning and contracting form:** The Government is moving towards a Medium Term Expenditure Framework, with MPW one of six government agencies selected to pilot the reforms. The reforms will help, among other matters, to improve and guarantee the level of resources dedicated to maintenance. In addition, the government is planning to pilot performance-based contracting for maintenance, which should improve the efficiency of the maintenance process.

35. **Oversight:** The Government is piloting a system of contract oversight that relies on contracted engineering firms acting as responsible agents rather than in an advisory capacity. In the new arrangements, the engineer specified in FIDIC contracts as the overseer is clearly specified by MPW to be the contracted engineering firm, rather than MPW officials. The system provides considerably greater authority and responsibility for successful project delivery to the engineering firm.

36. **Transparency and Disclosure:** The Ministry of Public Works website (*www.pu.go.id*) provides a high standard of information disclosure, exceeding the information availability of most public works ministries in developing countries. The website includes the Ministry's budget, planned roads and other works, the results of all tenders including winners and losers and bid prices, audit reports, and the quarterly financial reports for all World Bank projects (the last is not required by the World Bank).

37. **Procurement:** One international benchmark suggests general levels of integrity and transparency in public procurement in Indonesia are comparatively strong,[22] but this contrasts with Transparency International's assessment of general levels of corruption, which ranks

[22] OECD/DAC procurement benchmarking of Pillar IV covering integrity and transparency of procurement scored Indonesia at 69 percent.

Indonesia as 143rd of 179 countries. Certainly a number of issues and potential problems remain – many of which are being addressed by MPW. In particular, collusion and the related issue of fake bid securities remain a significant problem in road projects in Indonesia, affecting recent donor-funded projects. Not least for this reason, the MPW has moved to strengthen procurement systems and procurement support.

38. **To support the procurement process, MPW has introduced an advanced e-procurement system**. The system handled 4,000 contracts last year. It currently allows publication of advertisements of projects, availability of bidding documents on line for free download, online clarifications and queries and notification of contract awards on line. All Directorate General of Highways (DGH) national roads contracts in all regions and all value of contracts are processed through the system. To date MPW has been constrained in allowing submission of bids on-line due to the lack of digital signature legislation. However this has been recently enacted and DGH will move to full e-procurement in the near future. A team from MIT is currently analyzing the impact of the move to e-procurement. Early indications are that the change has resulted in a significant increase in the number of people obtaining bidding documents, but it is less clear that there has been a significant increase in the number of bids made.

39. **To support the multitude of procurement committees in MPW and improve the quality and promptness of their reviews, DGH is establishing a Procurement team staffed, funded and mandated to provide support to procurement committees in terms of advice, capacity building, review and streamlining of procurement procedures and promotion of standardized bidding documents.** AusAID is providing technical assistance in the establishment of the Procurement Team. DGH is also receiving financing from donors aimed at supporting different tasks related to the reform of public procurement on the national, ministerial and local levels. Particularly aimed at bidder collusion, on some projects the Government has piloted a system which allows for no prequalification, which keeps confidential the list of bidders who obtained bidding documents and which avoids physical pre-bid meetings.

40. **The Ministry is participating in a World Bank study of ways to improve competition in the road construction industry.** The study will include a survey of public works officials, local state-owned and private construction companies, leading potential international bidders, contractors, consultants, material suppliers, and industry associations, aimed at identifying the barriers to entry into the industry, and industry perceptions of the causes and effects of corruption. The study will also include a workshop with all stakeholders aimed at identifying reform recommendations.

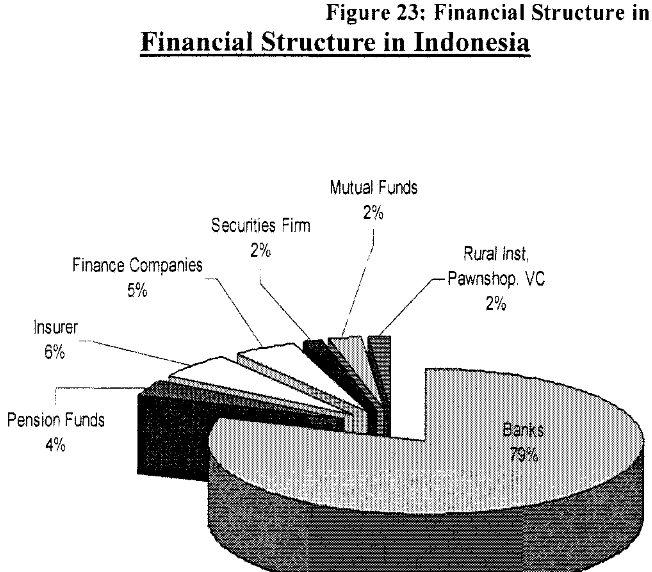
41. **Audit**: The MPW Inspector General (IG) has a broad set of priorities set by management covering the minimization of leakage, improved quality of public works and support for good practice in project management. The IG has recognized the need to move towards systematic risk assessment, develop a manual for technical audits and expand training. AusAID and the World Bank are working together to provide technical assistance in the implementation of its reform action plan.

Annex 3: Indonesia's Financial System

A. Structure and participants

1. **The Indonesian financial system consists of bank and non-bank financial institutions (NBFIs) whose assets** were expected to reach IDR2,942.2 trillion or 59.4% of GDP by the end 2008. Divided into commercial banks and rural banks, the banking sector is the largest segment of the financial system, controlling nearly 80 percent of its assets (see Figure 23). There are currently 124 commercial banks (including 5 state banks and 26 regional government banks) and roughly 1,770 rural banks in Indonesia. NBFIs consist of pension funds, life insurance, non-life insurance, mutual fund managers, venture capital, leasing companies, pawnshops and micro-finance institutions.

Figure 23: Financial Structure in Indonesia



Number of Institution

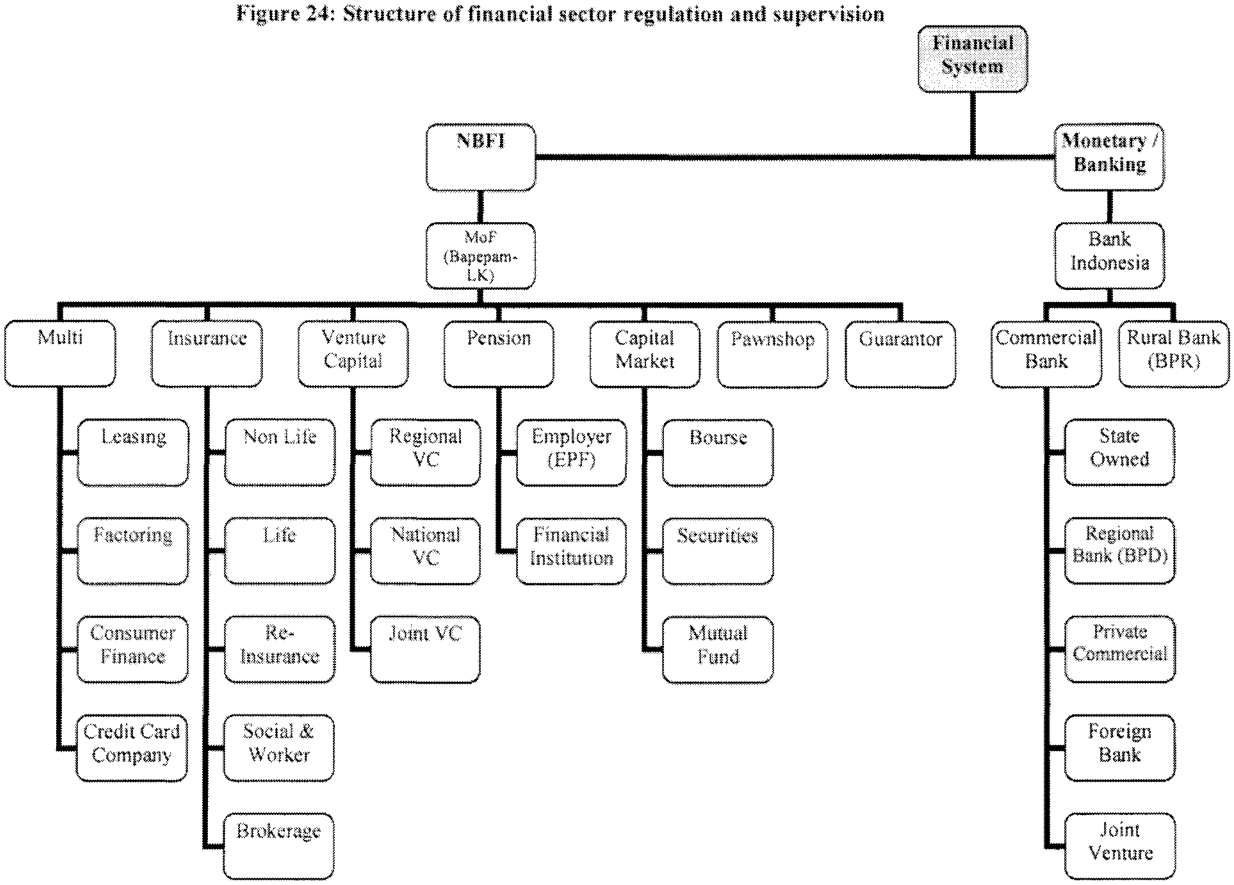
Banks	124
Rural Banks	1,772
Insurance	144
Life	45
Non-Life	90
Social Security	2
Civil Servants	3
Reinsurance	4
Pension Fund	282
Employer	255
Financial Institution	27
Securities	169
Multi Finance	205
Venture Capital	60
Pawnshop	1

Source: Bapepam-LK & BI

2. **Following the 1997/1998 financial crisis, the Government made significant efforts to strengthen the financial system in Indonesia.** The central bank law was amended and Bank Indonesia (BI) was made independent from the Government. As the nation's central monetary authority, BI regulates and supervises the banking sector.

3. **In recent years, the Government has focused greater attention on NBFIs in part because of the significant growth in this sector.** In 2007, NBFI assets increased about 47.8% to IDR664.3 trillion while bank assets grew by only 17.3%. In 2008, NBFI assets were estimated to have fallen 12.5% to IDR581 trillion primarily due to the global financial crisis. Until early 2005, two institutions within the Ministry of Finance had authority over NBFIs: Bapepam was in charge of capital markets and the Directorate General of Financial Institutions (DJLK) was in charge of all other NBFIs. To enhance the coordination and supervision of NBFIs the Finance Minister combined Bapepam & DJLK to form Bapepam-LK in late 2005.

Figure 24: Structure of financial sector regulation and supervision



Source: BapepamLK. BI, and Siamat, D."Manajemen Lembaga Keuangan".2004

B. The Banking Sector

4. **The 1997/98 banking crisis resulted in an overall restructuring of the sector.** It is much healthier now, with smaller numbers of non-performing loans, higher capital and strong profitability measures. The ratios of Non-Performing Loans, Capital Adequacy Ratio and Net Interest Margin to the end of February 2009 were 3.7%, 18% and 5.4% respectively. Most of the (previously private) banks taken over by the government during the crisis have either closed or been sold back to the private sector, mostly to foreign financial institutions. The Government has also started to sell partial ownership in state-owned banks. Currently, 3 of 4 state commercial banks (excluding the Exim bank) have listed roughly 30% of their stakes on the local stock exchange – Bursa Efek Indonesia.

5. **Banking sector loan growth remained sluggish for several years despite the restructuring and recapitalization process that ended in 2000.** Much of the growth came from the consumer loans market taking advantage of the strong growth in domestic consumption. Recent years have seen loan growth surge. In 2006, 2007, and 2008 loans grew by 13.9%, 26.5%, and 30.5%, respectively. Investment and working capital loans posted higher growth rates than consumer loans in recent years. This period of growth put pressure on banking sector liquidity and caused interest rates on deposits to rise. However Bank Indonesia

has recently taken measures to ease liquidity by extending repo contract maturity and cutting reserve ratios.

6. **The Indonesian banking sector also consists of Sharia-based institutions.** Although their market share remains small – IDR34.1 trillion or 1.4% of banking assets – their popularity has increased dramatically. Sharia banking assets jumped by 24.7% in the year ending December 2008. Today, the Sharia banking network consists of 3 Sharia commercial banks, 28 business units, and 124 Sharia rural banks.

Selected Account of Commercial Banks' Balance Sheet

Assets	2005		2006		2007		2008	
	IDR trillion	% of total	IDR trillion	% of total	IDR trillion	% of total	IDR trillion	% of total
Reserve & Securities	**253.8**	**17.30%**	**399.44**	**23.60%**	**526.28**	**26.50%**	**436.18**	18.88%
Loan	**695.65**	**47.30%**	**792.5**	**46.80%**	**1,002.01**	**50.40%**	**1,307.68**	56.60%
Working Capital	354.56	24.10%	414.75	24.50%	533.24	26.80%	684.67	29.63%
Investment	134.4	9.10%	151.21	8.90%	186.22	9.40%	255.90	11.08%
Consumption	206.69	14.10%	226.34	13.40%	282.55	14.20%	367.11	15.89%
Total Assets	**1,469.83**		**1,693.85**		**1,986.50**		**2,310.56**	

Liabilities	2005		2006		2007		2008	
	IDR trillion	% of total	IDR trillion	% of total	IDR trillion	% of total	IDR trillion	% of total
Demand Deposits	281.41	21.20%	338.01	22.20%	405.55	22.70%	430.00	20.52%
Savings	281.49	21.20%	333.93	21.90%	438.57	24.60%	498.58	23.79%
Time Deposits	565.03	42.60%	615.16	40.40%	666.71	37.40%	824.70	39.35%
1-month	439.76	33.20%	427.79	28.10%	487.3	27.30%	588.83	28.10%
3-months	69.6	5.30%	89.52	5.90%	86.66	4.90%	112.62	5.37%
>3-months	55.67	4.20%	97.85	6.40%	92.75	5.20%	123.25	5.88%
Total Liabilities	**1,325.54**		**1,521.51**		**1,784.26**		**2,095.78**	
Total equity	**144.29**		**172.54**		**202.24**		**214.78**	

Source: Bank Indonesia

C. Non-bank Financial Institutions

Capital Market

➢ *Stock Market*

7. **Indonesia's stock market has risen steadily since 2002. The Jakarta Composite Index (IHSG) was among the best performers in the region between 2004 and 2007.** The IHSG experienced a strong growth in 2007, posting an increase of 53% YoY on the back of bullishness in mining, plantations, utilities and financials stocks. Market capitalization also increased steadily, rising by almost 60% to IDR 1,988.3 trillion or 50% GDP in 2007. Foreign investors are active in the market. Indonesian stock holdings account for a significant 62% of market capitalization. Currently there are 482 companies listed on the IDX. Fifteen state-owned enterprises list shares on the IDX, accounting for 30% of market capitalization on average.

8. **The global financial crisis has had a significant impact on equity markets and the stock market index fell in 2008.** As of January 2009, the stock market index had declined by around 50 per cent from one year earlier, with one-quarter of the decline occurring after October 1, 2008. Mining and agricultural stocks fell most, reflecting declining expectations for

commodity prices. Financial sector stocks fell on average, by much less than the overall market, reflecting its strong capital base, low levels of non-performing loans and relative insulation from overseas developments especially in US financial markets. By the end of March the stock market index had rebounded slightly from its lowest level following the release of relatively good financial performance data by most major listed companies.

➢ ***Bond Market***

9. **The bond market in Indonesia consists of corporate and government bonds.** By the end of 2008, total pricipal value was IDR598.7 trillion or 12.1% of GDP, an increase of 6.9% from the value in the end of 2007. This consisted of IDR525.7 trillion or 87.8% of government bonds and IDR73 trillion or 12.2% of corporate bond.

10. **The government bond market is still relatively new.** From literally no government bonds prior to 1997, December 2008 they were worth IDR525.7 trillion (12.1% of GDP). Although much of this was initially driven by recapitalization of the banking system, recently the government has adopted a debt management strategy to expand the share of domestic debt in total public debt. The government now accesses bond markets for its regular financing needs. Annual net issuances are about 1% of GDP mostly in Rupiah (the government also issues global bonds denominated in US dollars for a part of its financing). In December 2008, the majority ownership – 53.6% - of government bonds is mainly with banking sector. Foreign investors hold around 16.7% of the outstanding principal values of Rupiah Government bonds. Mutual fund and life insurance companies are also investing in Government bonds. Historically, fixed-, variable- and zero coupon Government bonds are offered to institutional bank and NBFI investors. More recently, retail investors could also buy bonds through appointed agents - typically a bank or securities firm. Sovereign credit risk of Indonesia has improved since the 1997 financial crisis. In December 2008, Moody's Investor Services, assigned a Ba3 rating with a stable outlook, while Standard & Poor's gave Indonesian bonds a BB rating.

11. **The corporate bond market is much smaller market and tends to be illiquid.** Corporate bonds issuances had been active in recent years, taking advantage of benign interest rates and the availability of liquidity in the interrelation financial market. Most of corporate bonds were issued in Rupiah denomination although some large blue chip companies managed to issue US$ bond offshore. Most corporate bonds issuers were financial companies such as multifinance and banks that issue subordinated bonds to increase their 2^{nd} tier capital. Most corporate bonds were issued with five years maturity and purchased mainly by local institutional investors, such as life insurance and pension fund. These investors need long term investment and therefore tend to hold the bond until maturity. Consequently, trading in the secondary market is not active and market is not liquid. Throughout 2008, daily average transaction of corporate bonds IDR219 billion (0.3% of principal value).

12. **Indonesia's Islamic bond market is less developed than the conventional bond market.** The Government recently issued a law on Government Islamic bonds and has issued both Rupiah denomination and USD denomination Sukuk bonds. By the end of 2008, 18 corporate Sukuk had been issued worth IDR3.65 trillion or around 0.1% of GDP. In April 2009, the Government issued its first US dollar Sukuk worth US$650 million, and Rupiah Sukuk bonds worth IDR12 trillion.

➢ ***Rating Agencies***

13. **There are three credit rating agencies in Indonesia that are either affiliated with or subsidiaries of international rating agencies.** Pefindo is Indonesia's largest and oldest rating agency, established in 1994 through the initiative of Bapepam-LK and Bank Indonesia.

Pefindo is a private limited-liability company owned by 100 domestic shareholders, including pension funds, banks, insurers, securities companies, and the Jakarta and Surabaya stock exchanges. Pefindo is an affiliate of Standard and Poor's and adapts Standard and Poor's methodology in its rating process. Founded in May 2007, PT Moody's Indonesia was originally known as PT Kasnic Credit Rating Indonesia. It operates as Moody's Indonesia after Moody's Corporation acquired a 99% stake in January 2007. Fitch Rating is also represented in Indonesia.

➢ ***Mutual Funds***

14. **The mutual fund industry is the fastest growing NBFI. From 2001 until early 2005, the Indonesian mutual fund industry experienced** strong growth. The net asset value (NAV) rose from IDR8 trillion in 2001 to nearly IDR104 trillion in December 2004. The industry's growth was driven by the shift of individuals out of Rupiah time-deposit accounts in commercial banks and into mutual funds that invested mainly in Rupiah-denominated government securities, principally recapitalization bonds. The majority of investors are individuals, with institutional investors accounting for less than a quarter of NAV. However, massive redemptions rocked the industry subsequently, and assets under management fell to IDR 29.4 trillion by December 2005. The main causes were a sudden rise in interest rates that caused the value of "fixed income" mutual funds – which were the vast majority of funds – to fall, leading investors to panic. Some investors were miss-sold these products as deposit substitutes – with a higher return – and had not been adequately informed of the risks. The Net Asset Value (NAV) of the mutual fund industry grew by 79% in full-year 2007 to reach IDR92.2 trillions. There have been serious efforts taken by the Bapepam LK to avoid the repeat of the mutual fund crisis in 2005 and confidence of investors on the mutual fund industry had returned since that. However, toward the end of 2008 the global financial crisis had significantly lowered growth of mutual fund industry. The NAV of mutual funds had fallen by 20% to IDR74.1 trillions in 2008.

Insurance

15. **The Indonesian insurance industry is small and highly fragmented.** As of December 2008, there were 144 insurance companies in Indonesia totaling IDR178.6 trillion or 3.6% per GDP. The industry comprises 45 life insurers, 90 non-life insurers, 2 social insurance firms, 3 civil servant insurers and 4 reinsurance firms. Life, social insurance, civil servant, and non-life & reinsurance assets amounted to IDR89.9 trillion, IDR56 trillion, IDR6.3 trillion, and IDR26.5 trillion, respectively. In 2008, the insurance industry contracted roughly 20% from the previous year, causing industry penetration to fall from about 1.7% to 1.2% of GDP or IDR 60.7 trillion. It also capped a five-year period during which it grew by an average of 27.59% per annum, (from IDR50.12 trillion in year 2003 to IDR131.96 trillion in 2007). Premium during this period increased roughly 25.58% per year, from IDR26.40 trillion IDR64.49 trillion.

16. **Life insurance assets increased by 43.9% in 2007 to reach IDR102.2 trillion or 2.6% of GDP by December 2007.** The investment and gross premium also increased by IDR91.8 trillion (47.6% YoY) and IDR45.6 trillion (65.8% YoY) respectively. This growth has been attributed to rising awareness about life insurance generally and the popularity of the investment linked product. The unit linked market reached IDR29.3 trillion or 31.9% of life insurance investments by the end 2007. The global financial crisis significantly lowered growth in these industries. The NAV of mutual funds has fallen by 20% to IDR74.1 trillion. The industry association estimated that by the end of 2008 the gross premium growth declined from 66% to only 5.2%. Investment value declined less rapidly to IDR88 trillion because the

industry invested only small amounts in equity markets. The decline also reflects the increased numbers of policy surrenders.

Pension Funds

17. **The pension industry was developed as part of the national strategy to provide financial security in retirement.** In principle, Indonesian pension funds offer three products: (1) a publicly financed and managed pay-as-you-go system, (2) a mandatory funded individual account system linking contributions with benefits, and (3) voluntary individual or occupational pension savings. Pension funds can take the form of Employer Pension Funds (EPF) – which offer a defined benefit plan - or a Financial Institution Pension Funds (FIPF) – which offer a defined contribution plan. Typically, FIPFs are life insurance companies. The pension sector is small, controlling in total less than 3% of GDP in assets as of the end 2008. Pension fund assets increased from IDR91.3 trillion in 2007 to IDR104 trillion at the end of 2008. The value of the pension fund investment portfolio also grew by 8.4% from IDR91.3 trillion to IDR99 trillion in the same period.

18. **The EPF is the largest type of institution.** Its net assets increased to IDR90.2 trillion or about 12.5% YoY compared with FIPF's 24.3% YoY increase to IDR13.8trillion. Although net pension fund assets have increased, the number of EPFs decreased from 272 companies in 2006 to 262 companies in 2007. In 2007, 13 EPF closed voluntarily and most of their members moved to FIPF. As of December 2008, 255 EPFs operated in Indonesia.

Other Financing Companies

19. **The other financing companies in Indonesia consist of multi-finance (leasing and factoring) and venture capitals.** Leasing and factoring services provide financing for small and medium enterprises, while venture capital fosters innovation and entrepreneurship. Further development of these industries would broaden competition for financial services, introduce businesses and financiers to innovations such as cash-flow-based credit analysis, and provide small and medium enterprises with access to risk capital. The sector is small, but growing strongly in Indonesia, driven largely by consumer finance. To encourage further growth, the priorities are to put in place a reasonable but light level of regulation and supervision, allow depreciation of leased assets, widen the financing base, develop credit information systems, support corporate restructuring through private equity funds, separate the operation and management of venture capital funds, and develop legal trust vehicles.

20. **Total assets in multi-finance companies increased by 5.3% in 2008 to IDR134 trillion.** Financing activities also grew 23% to IDR135 trillion. Many large multi-finance companies are subsidiaries of banks so they can expand rapidly with the support of their parent companies. Most multi-finance business stem from car and motorbike financing and only marginally from machinery, heavy equipment etc.

21. Venture capital is highly underdeveloped in Indonesia. By the end of 2007, there were 60 venture capital companies: 27 national private companies, 26 regional companies and 7 joint venture companies. In 2008, the authorities removed 12 operating licenses. The number of venture capital market has fallen in recent years due to unprofitable business. Total asset of venture capital companies increased around 30% in 2008 to IDR4 trillion.

Interest rate regime

22. **Indonesia has a market-based interest rate regime**. There are no government controls on deposit rates and on the vast majority (more than 99 percent) of lending rates. The deposit insurance agency (LPS) sets a rate periodically that determines which deposits are eligible for coverage by the deposit insurance scheme. All deposits of a size below the maximum (increased from IDR100 million to IDR2 billion last November due to the ongoing global financial crisis and regional responses) are covered providing the deposit rate offered on them by the bank is equal to or less than the maximum rate established by LPS. Deposits carrying interest rates above the threshold rate are not covered. Lending rates are freely established by the banks based on market rates. The only exception is a partially guaranteed micro- and small credit program called Kredit Usaha Rakyat (KUR), established in 2007 with total outstanding loans currently less than 1 percent of total banking system loans. There are no controls on NBFIs lending rates as they do not accept deposits. The market interest rate is benchmarked and set based on the basis of the discount rate of the Bank Indonesia certificate (SBI).

23. **Lending and deposit rates have been market-based since 1993, because of financial sector reforms implemented during the 10-year period after 1983.** In the mid-80s, Indonesia reduced subsidized credit programs, removed deposit and lending interest rate controls and removed subsidies on state banks' deposit rates. Bank Indonesia moved away from direct monetary control through credit ceilings and adopted an open market regime. Although there still a number of credit programs (subsidized micro- and small-size credit for priority sectors run by Bank Indonesia or state banks for example), the interest rate of these credits were subsided at the lender level not at of the end-borrowers. After the 1997/1998 financial crisis, all credit programs previously managed by BI were stopped and the outstanding amount was transferred to a new institution, Permodalan Nasional Madani (PNM). The outstanding amount of these credits is declining significantly as it gradually winds down.

24. **At present, the only program that has government-determined interest rates is a new, partially guarantee micro- and small credit program called Kredit Usaha Rakyat (KUR) launched by the government in November 2007**. The interest rate on this loan is capped at 16% per annum and the maximum credit amount is US$50,000, however on average the loan size is less than US$1,000. This program is designed to help open access to bank credit for micro and small enterprises that are known to have an operating business and financial capacity to borrow (feasible) but have never borrowed from a bank (not bankable). KUR is a small credit program accounting for US$1.2 billion in loans as of December 2008 representing less than 1% of the total credit of the banking sector. The Bank is currently undertaking an assessment of the performance of this program at the request of the government.

25. **Non-Bank Financial Institutions (NBFIs) do not face interest rate controls on the funding or the lending side. They are legally prohibited from taking deposits from the public**. They mostly rely on bank loans and issuing bonds as sources for financing. The borrowing rate is determined by the prevailing market rate and reflects the degree of risk. On the lending side, NBFIs set their interest rates freely and face no controls.

D. Key Development Challenges

26. **The challenges facing Indonesia at this time can be broken down into the following general categories:**

➢ ***Impact of the global financial crisis on Indonesian banks***

Indonesia's banking system faces significant new challenges as a result of the continuing global economic downturn. However, both the nation's banks and its NBFIs are far better equipped to address these issues today in an effective and timely manner because of system-wide political and economic reforms launched in the wake of the 1997/98 economic crisis.

➢ ***The need to diversify the financial system***

The NBFI sector remains under-developed. The market remains vulnerable to future shocks because of the lack of strong institutional investors like pension funds and capital markets.

➢ ***System stability and improving the safety net***

The Government continues to improve both the regulation and supervision of the financial sector and the overall framework of the financial safety net, but much work remains to be done, particularly in strengthening the working relationship between BI and Bapepam-LK.

➢ ***Rationalization and consolidation***

Bank Indonesia has pursued a number of measures to rationalize and consolidate the industry, most recently enforcing a minimum Tier I capital of IDR80 billion for all commercial banks in December 2007 (IDR100 billion by December 2008-2010). Bapepam-LK has not been as aggressive as BI in this regard.

➢ ***Limited Access to financing***

More than 90% of all Indonesian businesses are micro-SMEs however the lack of available capital contrains their ability to grow. Banks have increased their lending to micro-SMEs 10% in the past year but it still lags. There is limited data on household access to financing, but preliminary results show fewer than 40% of households can access formal banking services.

➢ ***Limited availability of domestic long-term financing***

Banks and NBFIs are unreliable sources of long-term financing in Indonesia. Banks are heavily dependent on short-term deposits. Similarly, key potential NBFI capital sources are heavily invested in short-term bank deposits.

27. **Further details on the above issues are available in project files and in recent Bank reports.**

E. Key Reforms Implemented by the Government since the 1997/98 Crisis

28. **BI has improved and strengthened supervision and regulation of the banking sector including enforcement of regulations.** The regulation and supervision of the sector is broadly consistent with international practices. Although the regulations were on the books before the crisis, they were poorly enforced and this aspect has also been improved. BI has issued regulations on Good Corporate Governance that require the presence of a compliance director and independent commissioner. To create market discipline and consolidate supervision, BI also issued a regulation standardizing reporting and obliging all banks to publish quarterly financial statements. BI issued regulations on bankers' managerial

certifications and Know Your Customer (KYC) principles to prevent money laundering practices. The establishment of Debtor Information System was also initiated to provide information about all debtor classifications to prevent other bank or institution lending to debtors. At the end of 2007, Bank Indonesia undertook the following measures to mitigate potential risks: (i) intensification of BI-RTGS Adherence to Core Principles for Systemically Important Payment Systems (CP SIPS); (ii) payment system oversight to maintain a quick, safe and reliable BI-RTGS; (iii) business continuity plan for the payment system by conducting periodic trials using several scenarios to prepare and train operational personnel; and (iv) security upgrades for payment cards

29. **NBFI regulator Bapepam-LK has also implemented measures to create market discipline.** Bapepam-LK has standardized the financial reporting in each sector and made risk-based supervision the norm. In order to prevent money laundering through NBFIs, Bapepam-LK is expanding understanding of Know Your Customer principles. The Agency is also expanding the development and use of e-Reporting, e-Licensing, e-Registration and e-Monitoring systems. The Insurance and Pension Fund Laws are proposed to be amended. These revisions are aimed to strengthen regulation and supervision of these industries. Bapepam-LK has adapted Risk Based Capital (RBC) Approcach for Insurance and Risk Based Supervision for Pension Fund. All insurance companies were required to adopt Good Corporate Governance (GCG) principles and files GCG self-assessment reports to Bapepam-LK by November 2007. The conduct of mutual funds sales agents and the activity of commercial banks selling mutual fund products are better regulated and monitored by Bapepam-LK and BI. Bapepam-LK now also requires all fund managers to be licensed to issue products.

30. **The Government also established the Indonesia Deposit Insurance Company (LPS) to replace blanket deposit guarantees and insure depositors who have deposits below IDR100 million.** This has recently been increased to Rp. 2 billion in light of the global financial crisis and actions of neighboring countries.

31. **The Government continues to show a serious commitment to financial sector reform.** The Government launched the Financial Sector Policy Package (PKSK) in 2006, 2007 and 2008 to increase coordination between fiscal- and monetary authorities, continue the pace of reform, and strengthen banks, non-bank financial institutions, and capital markets. In May 2008, a third policy package was issued to address financial sector reform through clear policies, programs and output. Key areas covered by the packages include, regulations to mitigate the financial crisis, operationalization of the FSSF, preparation of the Financial System Architecture (ASKI), development and implementation of an Early Warning System, financial sector policy harmonization and expanding the scope of the credit bureau in order to strengthen the financial system.

32. **In response to the ongoing global financial crisis, the Government placed the task of reassuring financial markets at the top of its crisis response agenda.** The Government is acutely aware that maintaining financial market confidence is critical to Indonesia's overall economic prospects during the current crisis and fundamentally influences the ability of the Government to mobilize resources required to finance public expenditures going forward. It took several policy actions to reassure financial markets including, (i) strengthening the legal basis of the financial sector safety net, (ii) increasing the ceiling on deposit insurance from IDR100 million to IDR2 billion, and (iii) broadening of the types of assets that banks can use as collateral for emergency borrowing from BI in the event of banking crisis. The authorities have also requested an FSAP.

Annex 4: Major Related Projects Financed by the Bank and/or other Agencies

Sector Issue	Project Name	Rating	
		Development Objective	Implementation Performance
Bank-financed Projects			
Improving the delivery of urban services through enhancing the quality of urban infrastructure and strengthening the institutional and financial framework. Two complementary components: 1) support management improvements and institutional changes for implementation and sustainability of urban policy reforms, organizational performance, and urban services delivery; 2) aim at developing sustainable urban investments and common facilities, based on demand driven investment plans developed by Urban Local Bodies (ULBs).	India-Third Tamil Nadu Urban Development Project (I, II, III) - (P009872), (P050637), (P083780);	MS	MS
To build up India's capacity to attract private investment in infrastructure, pilot-test institutional and contractual arrangements under various conditions, foster efficiency in the delivery and use of selected infrastructure services, encourage efficient practices in construction and operation of infrastructure projects, and assist in alleviating financial and institutional constraints to expansion of infrastructure in India. Three interrelated components: 1) investment; 2) subproject preparation; 3) training and technical assistance.	India: ILFS – Private Infrastructure Financing Facility (P039935)	S	S
Partial debt financing through private sector financial intermediaries for eligible, government-endorsed infrastructure projects to be developed by the private sector. Two components: 1) lending; 2) technical assistance.	Bangladesh - Investment Promotion Financing Facility (P089382)	S	S
Increase the provision of basic infrastructure services in small and medium size cities; and strengthen Fonds d'Equipement Communal (FEC) as a commercially viable, autonomous financial institution for the municipal	Morocco – Municipal Finance (P005523)	S	S

Sector Issue	Project Name	Rating	
		Development Objective	Implementation Performance
sector. Two components: 1) municipal infrastructure - including eligible beneficiaries, on-lending arrangements, bank financing, and free limit and sub-loan approval; 2) institutional development.			
Promote the development of a credit market for municipal investment in Poland through long-term financial resources to commercial banks for municipal lending in infrastructure, and by helping banks identify and prepare a sustained pipeline of viable investment projects. The project consists of a single-currency loan to each of two selected commercial banks and will promote the channeling of donor-provided technical assistance resources to market participants.	Poland – Municipal Finance (P035082)	U	S

Development Objective/Implementation Performance Ratings:

HS (Highly Satisfactory); S (Satisfactory); U (Unsatisfactory); HU (Highly Unsatisfactory)

Annex 5: Results Framework and Monitoring

1. **Three types of monitoring and evaluation activities will be carried out during and after the life of the project:** regular monitoring, mid-term review (MTR) and impact evaluation. Regular/routine monitoring will be undertaken to collect and monitor in a systematic fashion changes in project output and outcome indicators over time (see table below). To a large extent, arrangements for the results monitoring will be integrated into the IIFF existing data collection and administration system. An independent impact evaluation will be conducted at the completion of the project to assess the achievement of the final development results. The impact evaluation will determine the project's contribution toward spurring long-term private investment in infrastructure, thereby helping more rapid growth and improving the delivery of critical infrastructure services.

Project Development Objective (PDO)	Project Outcome Indicators	Use of Outcome Information
The objective of the Project is to strengthen and further develop the institutional framework of the financial sector to facilitate financing of commercially viable infrastructure projects and thereby increase provision of private infrastructure in Indonesia.	• Increase in the number of commercially viable infrastructure projects achieving financial closure through long-term debt financing, other financial products, and advisory services from the the IIFF over the life of the project; • Increase in the amount of private capital (including long-term debt and equity) available for infrastructure projects over the life of the project. • Increased support to government's policy making in private provision of infrastructure through advisory services from the IIFF. • Increase in privately financed infrastructure in Indonesia.	**YR 0** The IIFF will come into existence upon the approval of the project. Therefore, the baseline of the number and value of projects financed by the IIFF is zero. Data from the feasibility study conducted for the IIFF will be used to provide a baseline for the overall market **YR 1 to 5** Annual outcome information from IIFF's financial reports will be used to track progress toward the PDO and to make changes in the project if necessary during implementation.
Outputs from each component	**Output Indicators**	**Use of Output Monitoring**
Long-term debt financing and provision of other financial products to commercially viable	Evidence of timely and satisfactory progress toward the delivery of this component outputs, as planned. The key specific	Output indicators will be used to ensure that infrastructure projects deemed eligible for IIFF financing by the IIFF management receive the funds and that Bank funds are used as per the business plan. Deviations of

Project Development Objective (PDO)	Project Outcome Indicators	Use of Outcome Information
infrastructure projects	measure that will be monitored is the value of Bank funds disbursed through the IIFF to eligible infrastructure projects. Other indicators such as number of commercially viable infrastructure projects financed by the IIFF, the number and value of equity investments made, the number of advisory services undertaken will also be monitored. Indicative revenues from these products and services are provided in the financial projections (Annex 6)	actuals from the business plan will be monitored and appropriate corrective actions recommended as part of ongoing supervision.

	Inputs: (Budget for each Component)	
Proposed single component: Long-term financing to infrastructure projects;	US$100 million Total Project Costs: U.S.$100 million	Implementing Agency Directorate general of State Assets. Ministry of Finance

Arrangements for Results Monitoring

	Targets				Data Collection and Reporting	
Project Outcome Indicators	**Baseline (May 27, 2009)**	**MTR**	**ICR**	**Frequency and Reports**	**Data Collection Instruments and Sources**	**Responsibility for Data Collection**
1. Increase in the amount of financing from Bank funds provided by the IIFF to commercially viable infrastructure projects through long-term debt financing and other financial products over the life of the project;	The IIFF will come into existence upon the approval of the proposed project. Therefore the baseline value is zero.	Evidence of upward trend. Intermediate targets for disbursements from bank loan are are indicated in the financial projections (Annex 6).	IIFF to have committed the entire Bank loan of US$100 million to commercially viable infrastructure projects based on financial projections	Internal monthly and quarterly reports and semiannual project reporting to WB	Quarterly reports from the IIFF	IIFF through its reports to SMI and other shareholders; GoI as implementing and monitoring agency and the Bank. IIFF will also have audited financial statements.
2. Increase in the amount of private capital (including long-term debt and equity) leveraged by the IIFF over the life of the project.	The IIFF has not yet begun operations. Hence baseline measure is zero	Evidence of upward trend as per financial projections (Annex 6)	The IIFF will have leveraged an increase in private capital for infrastructure projects over the life of the project. Total loans provided by the IIFF to be in line with projections in Annex 6.	Internal monthly and quarterly reports and semiannual project reporting to WB	Quarterly reports from the IIFF	IIFF through its reports to SMI and other shareholders; GoI as implementing and monitoring agency and the Bank. IIFF will also have audited financial statements.
3. Increase in number of privately financed infrastructure projects made bankable through the IIFF's advisory services. This	The IIFF has not yet begun operations. Hence baseline measure is zero.	Evidence of upward trend in revenues for advisory services as per financial projections (Annex 6).	The IIFF is expected to be obtaining revenue from advisory services in line with projections in Annex 6.	Internal monthly and quarterly reports and semiannual project reporting	Quarterly reports from the IIFF	IIFF through its reports to SMI and other shareholders; GoI as implementing and monitoring agency and

	Targets				Data Collection and Reporting	
Project Outcome Indicators	**Baseline (May 27, 2009)**	**MTR**	**ICR**	**Frequency and Reports**	**Data Collection Instruments and Sources**	**Responsibility for Data Collection**
indicator will be measured through the revenues obtained by the IIFF for advisory services as laid out in the financial projections.				to WB		the Bank. IIFF will also have audited financial statements.

Annex 6: Detailed Project Description

1. **Understanding the challenges facing the financial market in Indonesia (see Annex 3) and wanting to mobilize local sources of financing for infrastructure transactions**, the GoI has decided to establish a private sector facility to mobilize local currency financing -- the Indonesia Infrastructure Finance Facility (IIFF), to augment access to finance by introducing innovative financial products and directly addressing key bottlenecks that currently constrain private investment.

2. **The IIFF will be a non-bank private financing institution borrowing from the local debt market and lending to viable infrastructure projects.** The IIFF will mobilize resources from the Indonesian financial markets, mainly by issuing bonds to the market, and will lend to, invest equity in and provide other support to infrastructure projects. It will complement, rather than compete with, the existing financial institutions in Indonesia.

3. **The IIFF will have a highly-rated core group of initial investors and lenders**. GoI ($60 million), the ADB ($40 million) and DEG ($20 million) will be equity holders and the ADB will also provide a loan ($100 million) to the GoI to be on-lent by GoI to IIFF as subordinated debt. The GoI has requested equity investment from the IFC ($40 million) and a loan from the Bank ($100 million). This funding will put the IIFF in a sufficiently strong financial position to enable it to mobilize resources from the markets on a competitive basis. The Government's equity investment has been approved in its 2007 national budget and the resource shave bene provided to SMI for investment in IIFF. The terms of the GoI's loan to SMI and SMI's to IIFF will mirror the terms of the Bank's loan to Indonesia.

A. The IIFF Business Model

4. **The business model for the IIFF is simple. It brings together demand from two different sectors that are not currently met by public or market resources:**

- Commercially viable infrastructure projects looking for long-term local currency debt from a lender experienced in infrastructure finance, and
- Institutional investors and local banks looking for long-term placements with risk margins more attractive than the sovereign and large corporate offerings currently available.

5. **Infrastructure projects are currently financed in Indonesia through corporate debt (i.e. large utilities or companies borrowing money against their balance sheets to fund the construction of infrastructure).** The amount of debt available for infrastructure is therefore constrained by the capacity of corporate balance sheets and the willingness of those companies to allocate debt capacity to infrastructure as opposed to other investment opportunities. On the supply side, the amount of debt is limited by the ability of commercial banks to take long-term risks on the asset side of their balance sheets, given the very short duration of deposits on their liabilities side.

6. **In the short-term, the IIFF is likely to focus on projects currently in the market looking for debt (see discussion on potential pipeline in Section J below).** In the medium to long-term, it is expected that the availability of debt from the IIFF for well structured projects as well as it provision of advisory services will incentivize the development of the pipeline of good projects.

7. **Indonesian institutional investors and banks alike tend to invest their capital in short-term placements.** Available long-term placements are largely limited to sovereign or blue chip corporate bonds. Access to long-term higher yield placements such as from IIFF

should prove popular in the Indonesian financial market. This popularity should facilitate accessing Rupiah denominated debt as and when required for on-lending to infrastructure projects.

8. **In order to borrow locally at the right price and from the institutional investors described above, the IIFF will need to maintain an appropriately high credit rating.** The feasibility study undertaken for the project indicates that an appropriate level of capitalization for IIFF is about US$200 million equivalent in equity and a further US$200 million equivalent in subordinated debt from the GoI would provide IIFF with immediate access to long-term funds. These funds can also be leveraged (equity up to 10 times and subordinated debt up to 5 times) in terms of raising resources from the market. In future consideration could be given to additional credit enhancement of the IIFF, for example through a contingent facility or guarantee from an international financial institution.

9. **The source of the IIFF's competitive advantage can be broadly classified under four headings - funds, skills, credibility and relationships.**

➢ ***Funds***

10. **The IIFF will be a well capitalized financial institution.** This will give it adequate capacity for exposure to relatively highly geared capital intensive infrastructure projects. With the long tenor subordinated debt the World Bank and ADB are channeling through GoI, the IIFF can extend long-term financing without an asset liability mismatch on its books. No other institution in Indonesia can currently offer this. The capital base and credit rating of the IIFF will help it issue bonds that are perceived as investment-worthy by investors such as pension funds and insurance companies. The IIFF will maintain a high credit rating to enable access to funding at the most competitive rates. Though the IIFF will focus primarily on the domestic financial markets to mobilize resources, it will remain open to accessing international capital markets where such funding is available at competitive rates.

➢ ***Skills***

11. **To ensure the highest possible quality of its senior management and human resources, the IIFF will offer compensation that is in line with the market and effectively linked to performance.** Identifying a passionate, skilled and widely respected CEO and a core team assumes critical importance in this context. It will have much greater flexibility to do so than e.g. the sectoral or functional limits of government entities allow and a greater focus on developing expertise than the more broadly based banks. The IIFF will also explore links on a contractual arms-length basis with some of its shareholders who have the global expertise that IIFF can tailor to the Indonesian context. IFC's Investment Advisory team would be one such partner if credible channels for the transfer of knowhow to the IIFF can be established. The IIFF will induct – in addition to members appointed by its shareholders - independent members for the Board of Commissioners, distinguished in areas such as law, accountancy/audit, policy and regulatory reform, environmental/social issues, civil society organizations, etc. Such independent commissioners, apart from bringing skills and experience, can enhance the authority and independence of the institution.

➢ ***Credibility***

12. **The IIFF will start from a well capitalized base, with the major international institutions as shareholders, and with GoI supportive of its independence.** Although that does not assure its continued credibility, the IIFF can build on this initial positioning by establishing an independent board, a credible project appraisal process and an influential voice

for a commercial perspective in structuring private infrastructure. Over time, the IIFF will broaden its shareholder base to reinforce its independence and to ensure that it works at arm's length from GoI. Pending such broad-basing of shareholders, the IFIs as a group among the IIFF's shareholders are expected to provide the necessary counter-balance to any political interference by GoI. The IIFF will adopt the highest possible standards of corporate governance to ensure that its operations are transparent and subject to necessary checks and balances through independent commissioners on its Board of Commissioners. The IIFF's management will adopt environmental and social policies to identify, mitigate and monitor potential environmental and social impacts in compliance with Bank Policies and IFC PS, the GOI's applicable laws and regulations that will provide it with added credibility in the market. All of these issues will be articulated in the OM that is being prepared and the Ban will satisfy itself that the OM is acceptable prior to effectiveness of the loan.

➢ ***Relationships***

13. **The IIFF's initial promoters, i.e. GoI and the IFIs, will facilitate participation in the discussion of policy reform, the design of project structures and factors constraining project development.** IFIs and future private shareholders could potentially to contribute to capacity building at the IIFF in the initial years through funding, technical support, secondments etc. as permitted by their respective rules. GoI's support will be necessary for the IIFF to mobilize long-term funds from domestic financial markets. An active "arranger" role will require the IIFF to manage relationships with domestic banks, foreign banks, mutual funds, insurance companies, pension funds, private equity funds, hedge funds, underwriters, investment banks, etc.

B. Keys to Success

14. **The following factors are key success factors for IIFF:**

- **Government commitment:** GoI commitment is an important part of the IIFF's success, and strong government support thus far been a key driver of the initiative.
- **Strong commercial orientation:** The IIFF will operate as a commercial entity, with market-based rates and fees. It will respond to market demand, and adhere to global best practices with respect to corporate governance, operating policies and risk management, environmental and social policies, and governance and anti-corruption standards. It will provide the Indonesian market with a team of highly experienced infrastructure and limited recourse financing experts to lead on financing projects and defining good projects.
- **Innovative financial products:** The IIFF's product range will complement and enhance the capabilities of existing institutions in infrastructure financing, and respond to clear market demand to support only well-designed, financially viable projects; innovative financial products, supporting limited recourse financing and enhancing the project characteristics necessary to achieve bankability.
- **Project pipeline:** A reasonable pipeline of economically and financially viable projects is necessary for the IIFF's commercial success. IIFF's advisory services will assist in developing such a pipeline. Projects selected by the IIFF must comply with commercial criteria, and must not be captured by political or otherwise non-commercial interests.
- **Center of expertise:** The IIFF is expected to emerge as a national repository of experience and skills related to private financing of infrastructure. Accordingly, the IIFF is expected to contribute to ongoing policy reform initiatives, play a role in project development, and create funding opportunities for other investor classes.

C. Key Drivers for the IIFF's Capital Structure

15. **The IIFF's requirement for capital will be driven by the build-up in its asset portfolio.** A balance must be struck between maintaining high levels of capital adequacy to ensure a high credit rating (which reduces the cost of borrowings), and the return earned on the equity capital. Given that the IIFF will be able to establish the quality of its asset portfolio in terms of the level of non-performing assets ("NPA") only after being in operation for a few years, its initial credit rating will be driven primarily by its capital adequacy. This high level of capital adequacy, combined with competitive pricing of its products, could affect the return on equity ("RoE") in the initial years. This strategy is, however, expected to yield higher returns in the longer term as the IIFF establishes itself as a credible entity and enhances its profitability significantly through fee-based income. Based on the analysis of options using the financial projections, the IIFF will target a minimum Tier I Capital Adequacy Ratio ("CAR") of 20% in the long run. However, the IIFF will target to maintain a higher Tier I Capital Adequacy Ratio of 40% in the first three years (2009-2011), before stepping down Tier I CAR to 35% in 2012 and further to 25% in 2015 and 20% in 2018 .

D. Paid-in capital

16. **While the IFIs will seek approval for the IIFF's capital needs throughout the next several years, the capital will only be paid in as needed.** The minimum regulatory paid-in capital for the IIFF at the start of its operations is IDR 100 billion (about US$10 million equivalent). The subordinated loans being made available from the Bank and ADB, through GoI (see below) will ensure that further capital calls on shareholders will be made on an ongoing basis in line with business growth. IIFF will mobilize capital from the markets after it has gained critical size and momentum.

17. **The GoI has set aside IDR 600 billion (US$60 million equivalent) for its equity investment in IIFF.** SMI will provide the entire amount to the IIFF at incorporation. Part of these funds will meet SMI's capital contribution obligations with the remainder to be contributed as convertible debt. SMI will contribute its pro rata share against each call made by the IIFF against equity and the uncalled balance will remain as convertible debt. The convertible debt will be invested in government securities and the return provided to SMI. While IFC and DEG plan to obtain approval for US$40 million and US$ 20 million respectively of equity investment each, the ADB has obtained approval for its equity investment of US$40 million. Only a part of this will be paid up front (for a total equity capital of IDR 100 billion at start up).

18. **Other market participants will be invited to take equity positions.** Initial market reaction has been positive, in particular amongst those companies, financiers and investors wishing to have a presence in the infrastructure sector. However, in the current global climate, it is appropriate that establishment of the IIFF go ahead with the participation of the international financial institutions and private investors asked to come in as they become more favorable towards such investments. It is expected that at least two private investors – one foreign and one domestic will join in as investors during the first year of IIFF's operations.

E. Subordinated Debt

19. **GoI, through SMI, will lend the equivalent of US$200 million to the IIFF, drawing on funds provided for this purpose by IBRD and ADB.** The loan of $100 million from ADB will have a 25-year term, a grace period of 5 years, an interest rate determined in accordance with ADB's LIBOR-based lending facility and a commitment charge of 0.15% per annum. The

IBRD loan will be the Bank's VSL product with 24.5 years of maturity including 9 years under the standard terms applicable to Indonesia.

20. **Indonesia will on-lend these loans, in Rupiah, to SMI at SBI + 1% - its standard rate for such borrowings by any state owned enterprise**. SMI will, in turn, add a net spread of 0.5%[23]. All-in IDR funding costs to the IIFF will therefore be SBI + 1.5% which will still be competitive for on-lending to eligible infrastructure projects at market terms. The subordinated debt will be entirely callable and will be drawn down by the IIFF in line with its business requirements. This package of subordinated debt will ensure that the IIFF is adequately funded in its early years with capital calls on the equity as necessary keeping in mind the limit of subordinated debt to equity ratio of 2.5:1.

F. Funding Strategy

21. **The IIFF will raise initial financing from equity capital and subordinated debt.** As and when necessary, the IIFF will raise further funding from local financial markets. The IIFF is not expected to need additional capital for several years (based on what may be excessively conservative projections adopted here as the Base Case). It may be necessary to raise both additional equity and debt in the medium term. For market borrowings, the IIFF is expected to issue bonds on the domestic market. To the extent that there is a distinct cost advantage in accessing the global markets for foreign currency denominated debt after taking into account the cost of cross currency swaps and any credit enhancement measure used, the IIFF will explore such options. The IIFF will also consider additional capitalization via further private share subscription and eventually public offerings.

G. The Company

22. **The IIFF will be a form of non-bank financing institution, a limited liability PT, a professionally managed private company with the objective of maximizing shareholder value.** The company will be entirely private in nature, with no special audit, monitoring or regulatory rights of the GoI. The IIFF's mandate will be flexible to allow it to provide financial products that correspond to market demand, and the GoI has issued regulations to ensure that the IIFF has the legal mandate to provide this broad spectrum of financial products.

23. **The design of the IIFF is being driven by the Government in close coordination with the Bank Group and a Working Group of all stakeholders,** to ensure compliance with applicable regulations and maximum efficiency of structure (e.g. tax efficiency, management constraints and oversight). A legal review has been performed on the regulatory framework for IIFF and all constraints identified. A new presidential regulation has been issued that permits the operation of the IIFF in Indonesia. A ministerial decree operationalizing the Presidential decree has been issued. A thorough review of other similar entities from global experience has been conducted by the Working Group to ensure best practice is applied in structuring the IIFF. To shield the IIFF from capture by commercial, government, political, or other influence, the GoI's ownership stake – once private investors come in - will be capped at 30%, with the other 70% controlled by multilateral development banks and strategic investors with governance structures focused on minority shareholder rights and balanced management control.

➢ ***Corporate Governance***

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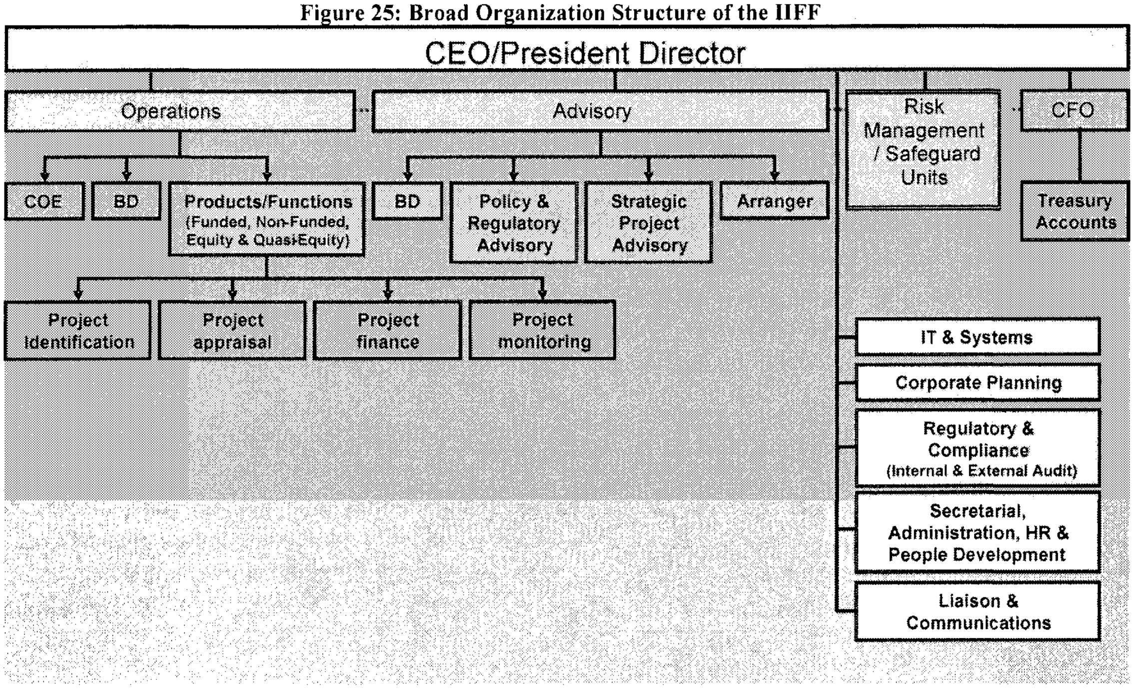
[23] In addition, SMI will be entitled to recover any taxes that it may actually paid by it as a result of lending to IIFF.

24. **A sound governance structure is key to the success of IIFF.** Substantial multi- and bi-lateral as well as private sector (domestic and international) equity participation will be the driver of sound governance. IIFF will adopt sound corporate governance practices to confirm its position as a credible institution in the eyes of all stakeholders. In addition, to improve transparency, IIFF will voluntarily comply with the listing requirements of the Indonesian Stock Exchange (IDX) from the outset, even though it is expected to be listed only in the medium-term. It is expected that this voluntary compliance will create IIFF transparancy level at the same as best practices level. In addition, being a non-bank financial institution, IIFF will be subject to the Indonesian regulatory requirements for such institutions with supervision being conducted by Indonesia's central bank, Bank Indonesia.

25. **Board representation by the equity investors will be critical** to ensuring that appropriate internal controls, risk management mechanisms including anti-corruption measures, and high quality human resources are adopted and implemented. IIFF will have a two tier board structure, i.e., the Board of Directors and the Board of Commissioners. The Board of Directors is responsible for the day to day management of the company and the Board of Commissioners is responsible for providing oversight function. It is expected that the IFC, ADB, and DEG will nominate one member each on the IIFF Board of Commissioners. To supplement the skills available to it, IIFF will induct a number of independent Commissioners who are highly reputed in areas such as law, accountancy/audit, economics, environmental and/or social issues, civil society organizations, etc. Such independent Commissioners, apart from providing credibility to IIFF and playing a vital role in corporate governance, will also make available to IIFF their skills and experience which will be invaluable.

26. **The detailed design of the IIFF's organization structure and various policies related to human resources are being developed with funding for consultants from AusAID.** These will be finalized leading up to the incorporation of the IIFF. The broad organization structure as envisaged for the IIFF on the basis of its positioning and product offerings is as follows:

Figure 25: Broad Organization Structure of the IIFF



27. **The figure above depicts the IIFF, under the leadership of its President Director, having two core business functions - Operations and Advisory.** The IIFF will maintain a clear separation between the businesses due to the inherent conflict posed by consulting and lending functions. Both Advisory and Operations would have their own set of products and these verticals shall operate independently of each other and report to President Director. Each vertical shall, therefore, also have its exclusive business development (BD) arm, operating independent of the business opportunities being tapped by the other. Operations shall essentially offer fund and non-fund based (i.e. credit enhancement type) products representing the Financier role of the IIFF and it shall constantly evolve/develop product offerings.

> ***Management***

28. **A critical determinant of the IIFF's success will be the caliber of the President Director and other senior Director level employees.** The Board will select a core management team to manage the IIFF. This may involve appointing a firm or consortia of firms through a management contract or individuals with incentive based performance contracts. The President Director will be a person with a strong vision for the IIFF and have extensive cross-sectoral and cross-functional experience in infrastructure to provide suitable policy and business direction to the IIFF team. The management team will need to perform three major functions: Corporate Management, Project Management and Fund (Cash) Management.

> ***Project Selection and Management***

29. **The IIFF will build its core competence through a team of professionals with specific experience in infrastructure project development and commercialization and the delivery of products that respond to market demand and the peculiarities of the infrastructure sector.** The project management team will have specific experience in limited recourse finance. To the extent appropriate, it will buy in specialist advice to perform due diligence on proposed projects and to design financial products.

30. **IIFF, as a Financial Intermediary (FI) supported by both the World Bank and the IFC, will finance mostly *private sector* subprojects.** The ESSF will comply with Bank Policies and IFC's Performance Standards for Social and Environmental Sustainability with the provision that the final ESSF will reconcile the differences between the PSs and the WB policies by following the guidance provided in the document "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC and/or MIGA", dated January 21, 2009.

31. **The project management team will be in charge of deal origination (both debt and investments), product development, proposal appraisal and the entire range of activities relating to the product delivery (i.e. documentation, monitoring, disbursement and recovery).** A project appraisal section of the Operations Manual will be prepared to support this team. This section will describe:

- Board's lending and investment approval policies
- Project cycle and selection criteria
- Approval process
- Portfolio limits

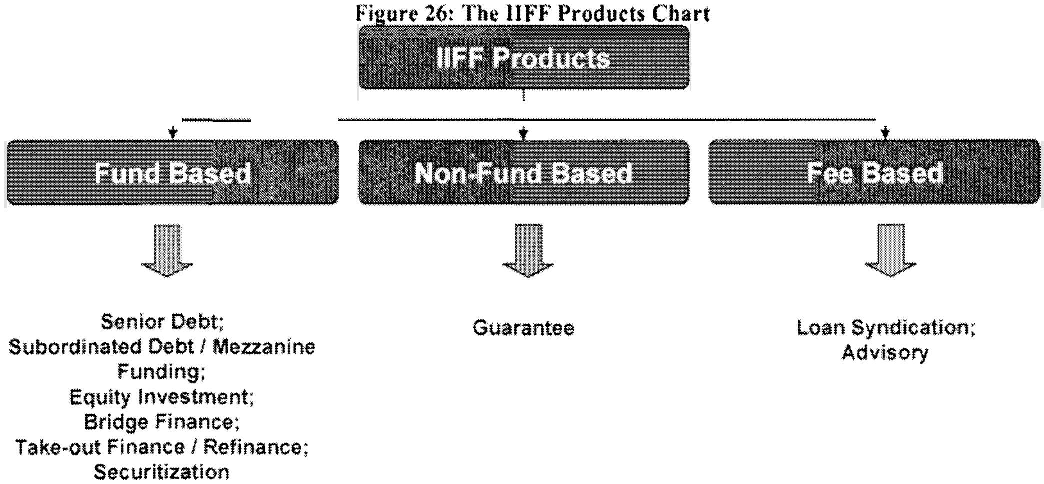
> ***Products***

32. **In its initial operation, the IIFF will focus on the following sectors:** (i) energy; (ii) water and sanitation; (iii) transportation; and (iv) industrial and commercial infrastructure.

The IIFF will focus on financially viable infrastructure projects. IIFF will have three main financial product categories (Figure 15):

- Fee based products provide fee income to IIFF (for e.g.: for its advisory services) and do not involve any disbursement of IIFF funds.
- Fund based products (for e.g.: senior debt, subordinated debt, mezzanine funding, equity investment, bridge finance, refinancing, securitization) do involve actual disbursement of Bank (through IIFF) funds. The first five categories - senior debt, subordinated debt, mezzanine funding, equity investment, bridge finance - all involve financing for new infrastructure. The final two categories (refinancing and securitization) involve raising financing on the basis of existing infrastructure (effectively as collateral), typically for the purpose of building new infrastructure.
- Non-fund based products - such as guarantees - involve contingent disbursement of Bank funds (through IIFF). If a sub-project to which IIFF has a provided a guarantee defaults on its loan obligations to another financial institution or other investors, only then is IIFF required to meet the subprojects' obligations instead of the sub-project. In addition to providing long ts purpose is to bring private sector investment to projects that would otherwise have difficulty receiving such investment or where such investment would otherwise attract an excessively high interest rate, short tenor or strict terms that would make it unattractive or not feasible for private sector project developers. The IIFF products can be structured to mitigate different levels of project financial risks to make the project "bankable".

Figure 26: The IIFF Products Chart



➢ *Funded Products*

33. Offering traditional plain vanilla products initially will create in-house expertise and relationships with market participants and will give the IIFF the opportunity to establish sound appraisal systems and sector knowledge.

34. **Senior Loans:** Loans of up to 15 years are expected to be a unique selling proposition for the IIFF in the initial years of operation. Currently, term loans in Indonesia seldom exceed 5 to 7 years and the majority of term loans are on a floating rate with lending rates typically in a range of 300 – 500 bps above Jakarta Interbank Offered Rate ("JIBOR").

35. **Bridge Finance:** In Indonesia, this funding is available for a tenor of 3 months to 1 year with interest rates currently ranging from 15 – 20%. IIFF could potentially lengthen the maturity of these loans.

36. **Take-out Finance and Refinance:** The difference between take-out finance and refinance is that the commercial terms and spreads for the second loan are agreed to at the time of the first loan itself in case of take-out finance, whereas in refinance the commercial terms and spreads for the second loan are negotiated at the time of the transaction. Refinance can be provided to infrastructure providers or to commercial banks. Refinance is a product that will enable the IIFF to build its asset portfolio, while also freeing up resources for additional infrastructure creation. For take-out financing, the IIFF will have to actively seek opportunities among loans to PPP projects that are yet to be disbursed by commercial banks, which is again a significant opportunity in Indonesia.

37. **Subordinated Debt:** As a subordinated debt provider, the IIFF could provide first loss coverage to the commercial bankers, encouraging them to lend more to infrastructure projects and thereby improve the flow of funds.

38. **Securitization:** BAPPEPAM-LK is keen to develop this product in Indonesia as it can add significantly to liquidity in the system. The IIFF could contribute to the development of the market for securitised paper in the long run but will not be active in this product in the short term as the regulatory constraints are yet to be addressed. In the interim, the IIFF could explore possibilities of buying loans extended to infrastructure projects from the books for commercial banks. These loans have been typically extended on recourse basis by the commercial banks. By purchasing these loans and converting them into project finance loans (i.e. on non-recourse or limited recourse loans), not only the IIFF can quickly build portfolio of quality assets but also unlock sponsors' balance sheet capacity to undertake more infrastructure projects.

39. **Equity:** the IIFF can consider investing both in projects and in holding companies. It can exit either through the private placement of its equity stake to other investors or through the Initial Public Offerings (IPO) route. Equity investment by the IIFF will address a critical gap in the Indonesian market while also providing the base for the IIFF to enter into fee-based fund management once it has established its credentials.

➢ ***Non-funded Products***

40. **Guarantees/credit enhancements:** Non-fund based products are unusual for Indonesian commercial banks, except where default guarantees are offered in support of contractors to project owners. This is likely to offer the IIFF an area of opportunity.

41. **Stand-by Finance:** Cost escalation during the construction phase of infrastructure projects is a key risk, often covered via stand-by loan facilities, and which the IIFF will make available. If drawn down, these loans will be a short-term bridge until the sponsors have either found longer term debt or provided additional equity to finance the cost escalation.

➢ ***Fee-Based Products***

42. **Syndication:** Given its role as the infrastructure expert in Indonesia, the IIFF can earn fee income by mobilizing debt from other lenders for infrastructure projects.

43. **Advisory:** As part of its positioning, and particularly in the first few years of operations, the IIFF will be an advisor to GoI entities, advising on policy reform initiatives thereby providing the investors' perspective to such initiatives and reforms. The IIFF will attempt to generate some revenue from such advice from IFIs and other agencies promoting

policy change in infrastructure in Indonesia. While this activity is unlikely to prove fully cost recovering, it will be important to help establish the IIFF's credibility and access to emerging opportunities across the infrastructure sector. Experience elsewhere supports the view that advisory services from such institutions can have a significant impact in creating an enabling environment and boosting the project pipeline.

44. **Seen broadly, the IIFF's advisory business is expected to encompass three distinct types of assignments in the initial years:**

- Non-billable assignments related to policy and regulatory reform taken up to support ongoing initiatives by the GoI and IFIs. Such assignments are expected to be significant in the initial years. IIFF's ability to take on such assignments is based on the support of its shareholders (GoI and the IFIs) who are actively involved in policy and regulatory reform.
- Billable assignments related to policy and regulatory reform
- Billable assignments related to project development where the IIFF will advise state-owned and private-sector companies in how to prepare, structure and execute infrastructure transactions.

H. Project pipeline

45. **The success of the IIFF depends on its ability to identify financially-viable projects in which to invest.** In the short-term, the IIFF is likely to focus on financially-viable toll roads and small- to medium sized independent power producers (IPPs) currently in the market (both financing and refinancing). It would also look at potentially securitizing existing assets to create capacity for the owners to undertake new projects. The financial model assumes very small market shares for the IIFF – less than 5 per cent – to establish the IIFF's viability. The IIFF will also play a key role in developing a pipeline of projects through its advisory services. As other elements of the infrastructure sector in Indonesia see the value of properly designed PPP projects and the ability of the IIFF to mobilize local currency limited recourse, long-tenor financing for such projects, the pipeline of opportunities for the IIFF is expected to grow.

I. Demand Forecasts

46. **While various infrastructure sectors differ in terms of the readiness for PPP projects, many sectors are currently at a stage where PPP projects may be expected to emerge over the next few years.** The demand side case for creating the IIFF is further established by a quantification of the project pipeline across different sectors. Based on information collected from various players in an exercise aimed at establishing the feasibility of the IIFF, the pipeline of identified infrastructure projects at various stages of the project development cycle is as follows:

Table 9: Summary of Infrastructure Project Pipeline in Indonesia (US$ Mn)

Sector (number of projects) / Project Stage	Planning Stage but Procurement Not Started	Procurement Process Started but Concession Agreement not Signed	Concession Agreement Signed but Not Reached Financial Closure	Financial Closure Achieved	Under Construction	Operational	Only Investment Figure, Other Details NA	Total Sector Investment
Power (160 nos.)	12,294	14,993	3,094	-	770	-	3,779	34,931
Telecommunications (3 nos.)	1,500	-	-	-	-	-	-	1,500
Toll Roads (63 nos.)	7,110	3,223	6,104	4,183	506	1,013	-	22,139
Gas (12 nos.)	1,300	-	-	-	-	-	874	2,174
Water (24 nos.)	219	-	-	-	-	-	398	618
Ports (37 nos.)	544	469	-	-	-	-	2,101	3,114
Airports (17 nos.)	100	-	-	-	-	-	3,120	3,220
Railways (14 nos.)	6,090	-	-	-	-	-	2,151	8,240
Waterways (1 no.)	97	-	-	-	-	-	-	97
Sub-national projects (9 nos.)	13	-	-	-	-	-	-	13
Total Investment Pipeline	**29,267**	**18,685**	**9,198**	**4,183**	**1,276**	**1,013**	**12,423**	**76,045**

Source: CRIS Analysis

47. The total investment envisaged through 2015 in infrastructure on the basis of identified projects currently at different stages of the development cycle is thus estimated to be above US$76 billion. Almost half of this investment is expected to take place in the Power sector. This is followed by development of Toll Roads with estimated investment at US$22 million which makes up 29% of the total and Railways at US$8 billion (11% of the total). Even taking a conservative view about the proportion of projects that are bankable and the IIFF's share of such projects (as summarized in the tables below), the financial projections prepared for the IIFF indicate that the entity would be able to establish an asset base that is viable in terms of the return generated for equity investors.

48. **The likely sanction of debt financing by the IIFF based on the above assessment is:**

Table 10: Projected Sanction by the IIFF for Power Sector Projects

Projected Sanction by the IIFF for power sector (US$ Mn)	2009	2010	2011
Projected sanction of refinancing by the IIFF - power sector	3	4	4
Projected sanction of debt funding by the IIFF - power sector	50	53	114
Projected sanction of equity investment by the IIFF - power sector	0	0	6
Total funding of power sector (refinancing+debt+equity)	53	57	124
Total funding of power sector during 2009-11	234		

Table 11: Projected Sanction by the IIFF for Toll Road Projects

Projected Sanction by the IIFF for toll roads sector (US$ Mn)	2009	2010	2011
Debt funding	25	41	104
Equity funding	0	0	5
Total funding of toll road sector (debt + equity)	25	41	109
Total funding of toll road sector during 2009-11	175		

Table 12: Projected Sanction by the IIFF for Other Sectors

Projected Sanction by the IIFF for other sectors (US$ Mn)	2009	2010	2011
Debt funding	7	28	46
Equity funding	0	0	7
Total funding for other sectors (debt + equity)	7	28	52
Total funding for other sectors during 2009-11	87		

49. **The total estimated opportunity and the effective market shares assumed for the IIFF over the period 2009-2011 are summarized below.**

Table 13: Estimated Opportunity and Effective Market Share Assumed for the IIFF

Details	2009	2010	2011
Estimated opportunity in power - debt financing (incl. refinance)	3,867	4,973	4,987
Estimated opportunity in toll road - debt financing	1,523	1,575	2,853
Estimated opportunity in other sectors - debt financing	2,724	4,604	5,213
Estimated opportunity in equity funding - all sectors	2,101	3,233	6,349
Sanction in power - debt financing (incl. refinance)	53	57	118
Market share of the IIFF	1.37%	1.14%	2.37%
Sanction in toll roads - debt financing	25	41	104
Market share of the IIFF	1.66%	2.60%	3.64%
Sanction in other sectors - debt financing	7	28	46
Market share of the IIFF	0.25%	0.60%	0.88%
Sanction in equity funding	0	0	17
Market share of the IIFF	0.00%	0.00%	0.27%

Annex 7: Project Costs

Project Cost by Component and/or Activity	Local US$ million	Foreign US$ million	Total US$ million
LT Finance to the IIFF	0	100	100
Of which IBRD	0	100	100
Total Baseline Cost	0	100	100
Physical Contingencies	0	0	0
Price Contingencies	0	0	0
Total Project Costs	0	100	100
Of which IBRD	0	100	100

Annex 8: Implementation Arrangements

Executing Agency

1. **The office of the Directorate General of State Asset Management, Ministry of Finance, will be the Executing Agency for the Bank's loan.** DG Treasury will be responsible for the execution of the subsidiary loan agreement between the GoI and SMI and for processing and transferring loan funds to SMI.

Implementing Agency

2. **The IIFF will be the Implementing Agency for the Bank's loan.** The IIFF will be established after Board approval and its staffing and final operations manual will be put in place prior to project effectiveness. The Bank's lending instrument for this project is a Financial Intermediary Loan, or "FIL". The Bank will provide an investment loan to the Borrower. The Borrower will in turn provide these funds to the IIFF – the sole participating financial intermediary – through SMI. The IIFF will in turn, use these funds to provide predominantly long-term loans (as well as investments, guarantees and other financial products) to commercially viable infrastructure projects. IFC will invest up to an equivalent of US$40 million in the IIFF's common equity.

3. **Drawdowns from the loan will be made on the basis of requests from the IIFF to SMI, which in turn will be transmitted to the Government, and the Government will request the Bank for drawdowns.** Bank funds will be provided to the Government, which will on-lend to SMI through a subsidiary loan agreement. The SMI will provide these funds to the IIFF through a subordinated loan agreement. Indonesia will borrow from the Bank in US$: the GoI will provide equivalent IDR funds to SMI at its standard interest rate for such subsidiary loans (applicable to all state owned enterprises) at SBI+ 1%. The difference between this rate and the Bank's lending rate to Indonesia effectively represents the premium charged by the Government for taking on the exchange rate risk. SMI in turn will add a spread (0.5 percent) towards its administrative expenses and on-lend these IDR funds to the IIFF[24]. There are no subsidies being provided to the IIFF and it will raise its funds at rates comparable to the market. Further details of funds flow and disbursement arrangements are provided in Annex 10.

4. **The subsidiary loan agreement and the subordinated loan agreement will contain undertakings by SMI and IIFF, respectively, to implement all fiduciary and implementation undertakings made by GoI to the Bank.** The Bank's loan to GoI, as well as the subsidiary loan agreements will also contain a subordinated debt to equity ratio of 2.5 to 1 that will contractually ensure that sufficient equity capital is provided to the IIFF by its shareholders[25].

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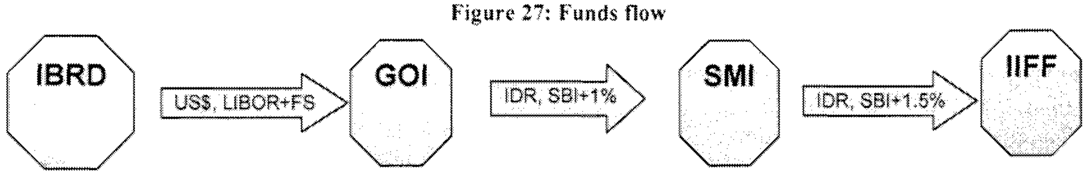
[24] The net spread charged by SMI to IIFF will be 0.5 percent over the cost of funds that SMI receives from the Government. In addition, the subordinated loan agreement will specify a formula by which SMI will be entitled to recover any actual tax payments that it may incur as a result of the lending to IIFF.

[25] This ratio is determined by the financial projections for IIFF.

Figure 27: Funds flow



5. **The Government has established the fully publicly-owned holding company PT. Sarana Multi Infrastruktur (SMI) as the vehicle through which it will invest in the IIFF.** SMI is a 100% State Owned Enterprise under the Ministry of Finance whose purpose is to invest in infrastructure financing institution(s) or otherwise provide funds for infrastructure financing. The Government has allocated an initial capital commitment of IDR 1 trillion to SMI through the national budget approved by parliament. Of this amount, SMI will invest up to IDR 600 billion (about US$60 million equivalent) in the IIFF for a minority equity stake on behalf of the Government. This will be invested initially pro-rata with the IFI investors, with a combined initial investment of IDR 100 billion (approximately US$10 million equivalent)[26]. With IFC, ADB and DEG initially investing 19.9% each, SMI will initially contribute just over 40% of the common equity. The balance of the IDR 600 billion, pending its being paid in as equity, will be contributed as convertible subordinated debt, earning a return based on current market rates. As private investors join the equity, SMI will reduce its percentage stake (in absolute terms, its equity contribution will grow) to 30%. Further private investment beyond that point will lead to a dilution of the IFI holdings. The balance of SMI's funding will be applied in complementary efforts to develop private investment in infrastructure. The equity investors are developing an approach for such efforts of SMI for discussion with the Government. It is likely that SMI would potentially support project preparation (eg. in the municipal water sector) that could be considered by IIFF. SMI could also potentially make some investments alongside IIFF as a means to develop expertise in infrastructure sectors.

6. **SMI will also channel the Bank's and ADB's sovereign loans to the IIFF.** The terms and conditions of this pass-through will be back-to-back, with fees, margins and other costs at cost-recovery levels with no subsidies involved. They will also include fiduciary and implementation undertakings by SMI commensurate with those contained in the Bank's legal agreements with the GoI. SMI has been established with a lean staffing and management structure, with a Board of Commissioners and a Board of Directors reflecting its role as an investment vehicle for the Government.

Operations Manual

7. **IIFF will be established only after approvals are obtained by the Bank, IFC, and other investors of their respective loans and equity investments.** The detailed operational guidelines that IIFF will follow can only be finalized after the establishment of IIFF in collaboration with the management of IIFF. An OM acceptable to the Bank is being prepared for adoption by the IIFF. The OM will include, *inter alia*; the policies and procedures to be

[26] In line with the business growth of IIFF, this equity will be built up to $200 million.

followed by the IIFF to address operational, credit and foreign exchange risks in its day-to-day operations; agreed financial management, procurement, and disbursement policies and procedures; environmental and social policies and procedures to be followed in line with the Bank's policies, IFC's PSs and applicable Indonesian laws and regulations; a detailed framework for the measurement and monitoring of outcomes; guidelines on preventing fraud and corruption in line with WBG policy; the supervisory arrangements for the project; and terms and conditions for agreements between IIFF and subproject companies reflecting all the above. These are all key elements in ensuring effective project implementation. The adoption of an Operations Manual acceptable to the Bank is a condition for effectiveness of the loan. The adoption and ongoing application of the operations manual is a covenant in the Loan Agreement between the Government and the Bank and the Project Agreement among SMI, IIFF and the Bank, and will be included in the subsidiary loan agreement and subordinated loan agreement from the Government to SMI and from SMI to IIFF, respectively.

Project Supervision

8. **The IIFF will be established once the approval of all development partners for their equity and loan commitments has been obtained.** While the OM will lay out the procedures that the IIFF will follow, and while this obligation will be included in the legal agreements, project supervision will have to ensure that it is following the established norms. It is expected that in the initial stages this project will need intensive supervision, at least until the IIFF has established itself. Bank supervision will need to focus on (i) the Government's role in the IIFF and in its requests to the Bank for drawdowns of loan funds (ii) SMI's role in the IIFF and in passing-through Bank funds to the IIFF (iii) the IIFF's adherence to the OM and its overall functions and (iv) development outcomes in the form of the performance of projects financed by the IIFF. To provide the context for this supervision, the Bank's project supervision team will need to coordinate closely with the team working on broader infrastructure sector issues, especially as they relate to the framework for private participation in infrastructure, and with the IFC supervision team.

9. **IFC's supervision will begin from first equity disbursement and continue on a quarterly basis for as long as IFC remains an equity investor.** It will focus on the detailed monitoring of operational performance, management quality, environmental outcomes, compliance with each covenant of the Shareholders' Agreement (and by association, the Articles of the IIFF), adherence to integrity standards, financial results, the evolution of the valuation of the equity holding, and a comparison of expected and actual development outcomes.

Bank/IFC Conflicts of Interest

10. **The Bank and IFC teams are consulting with the World Bank Group Conflicts of Interest Office (WBGCOI)** regarding the possibility of potential or perceived conflicts of interest arising in relation to the two institutions' participation in the Project, viz. establishment of the IIFF. The Bank's funds will be provided to Indonesia; these will in turn be on-lent to IIFF (through SMI) as subordinated debt. IIFF will on-lend these funds to eligible infrastructure subprojects. The terms and conditions of the Government's subordinated debt to IIFF will mirror the terms and conditions of the Bank's loan to Indonesia. IFC, on the other hand, plans to invest $40 million directly in the common equity of the company. In the view of WBGCOI, the collaboration of the Bank and IFC in the Project is not likely to raise significant conflicts of interest risk, except in circumstances where financial condition of the IIFF materially deteriorates. Under such circumstances, given that the terms and covenants of the Bank's loan to Indonesia, and Government's sub-debt to the IIFF (through SMI) are substantially the same,

any requests for waivers of covenants and terms under the subordinated debt by the IIFF would likely trigger a de facto mis-alignment of interest between the Bank and IFC. Accordingly, the WBGCOI Office advised the Bank and IFC teams to put in place conflict mitigation measures, including establishing separate teams with no overlapping members to handle the Bank's and IFC's respective investments in the Project, and adopting appropriate information barriers to prevent sharing of confidential information between the teams without appropriate consents. In response to this advice, the Bank and IFC have agreed that there will be separate teams as suggested. The teams would continue discussions with WBGCOI and arrive at agreements on appropriate information sharing keeping in mind confidentiality and conflict of interest aspects on one hand and the synergies and reduced transactions of joint-supervision (to the extent practical) on the other. WBGCOI also advised the teams that these arrangements be disclosed to the Government, IIFF and other stakeholders in writing and the teams have agreed to do so after these arrangements have been agreed upon. The team will continue consulting with the WBGCOI Office as the project progresses and will implement appropriate conflicts of interest mitigation measures based on WBGCOI Office recommendations.

Annex 9: Procurement Arrangements

A. General

1. **Bank-funded procurement for the proposed project would be carried out in accordance with the World Bank's** "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004, revised October 1, 2006 (the Procurement Guidelines); and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004, revised October 1, 2006 (the Consultant Guidelines) and the provisions stipulated in the Financing Agreement. The general description of various items under different expenditure categories is provided below. For each contract to be financed by the Bank Loan, the different procurement methods or consultant selection methods, the need for prequalification, estimated costs, prior review requirements, and time frame will be agreed between the IIFF and recipients of sub-loans in a Procurement Plan that should be developed for each sub-loan. The Procurement Plan for each sub-loan will be updated at least annually or as required to reflect the actual implementation needs and improvements in institutional capacity.

2. **IIFF is expected to invest in selected infrastructure projects under** loans to private sector firms and/or state owned enterprises. In addition, consultant services are expected to be procured by IIFF to support their operations and advisory services capabilities. These consultant services are to be wholly financed by IIFF own funds and would be procured in accordance with the procurement procedures to be developed for IIFF's own procurement. As for sub-loans, and since the Bank provided funds will be pooled with funds from other sources, it will not be possible to track financing of specific contracts/expenditures and the proposed procedures will apply to all funds that IIFF will provide for sub-loans over the life of the loan.

Procurement under IIFF loans to private sector firms and/or state owned enterprise in public sector:

3. **Procurement of Works**: Civil works to be procured under IIFF loans to private sector firms and/or state owned enterprise may include projects in Power sector, development of Toll Roads, Railways, Water projects, Ports, Airports etc.... Procurement of works would mainly be undertaken by respective recipients of IIFF loans using the established private sector and/or commercial practices in accordance with paragraph 3.12 of the Bank's Procurement Guidelines. The following private sector and commercial practices are proposed to be used for the project: For small works (specific threshold will be established in the procurement section in the Project Operations Manual), entities may negotiate a contract directly with a contractor with due attention to qualifications and reputation of the contractor as well as past experience. Such small works may also be directly constructed by the entities if they have adequate construction experience, personnel and equipment capabilities. For large works contracts, the entity may invite quotations from a minimum of three qualified contractors to assure competitive prices. These practices can be basically acceptable to the Bank considering the incentive of IIFF borrowing firms in ensuring economy and efficiency of their borrowed funds due to commercial interest rate they have to pay to IIFF.

4. **Procurement of Goods:** Since the list of potential subprojects is open, Goods under loans from IIFF to its borrowers may include a wide variety of equipment and related services. These goods would be procured by respective sub-borrowers using the established private sector and/or commercial practices in accordance with paragraph 3.12 of the Bank's Procurement

Guidelines. The following commercial practices are intended to be used for the project: for small goods items (specific threshold will be established in the procurement section in the Project Operations Manual), direct contracting may be used. Direct contracting may also be used for equipment of proprietary nature. For large contracts of goods, shopping would normally be used by comparing at least three quotations from qualified suppliers.

5. **Selection of Consultants:** Consulting services from IIFF to sub-loan recipients may include detailed feasibility studies, preparation and appraisal of engineering design, procurement support, construction supervision, technical transfer, etc. These consulting services would be procured by respective sub-loan recipients using established commercial private sector and commercial practices in accordance with paragraph 3.14 of the Bank's Consultant Guidelines. The following commercial practices are proposed to be used for the project: for small contracts (specific threshold will be established in the procurement section in the Project Operations Manual), comparison of qualifications of several firms may be used. A proposal can be invited from one firm selected based on qualifications and experiences This procedure is along the principles of the Bank's method of Selection based on Consultant's Qualification (CQS) method. For larger contracts, consultants would be selected through a more competitive process along the main principles of the Bank's Quality Based Selection (QBS) process. Under such a process, the sub-loan recipient would assess a short form of technical proposals from at least three qualified consultants. During the first phase the qualifications, capabilities, methodology and qualifications of proposed consultants' expert teams would be compared. The most qualified consultant will then be invited to submit a full technical and financial proposal which will be negotiated with the sub-loan recipient as needed.

6. **The above procurement methods and thresholds will be elaborated in the procurement section in the Project Operations Manual that is currently being developed for IIFF.** This Manual will be subject to the Bank review and approval and the draft of which will be ready by loan effectiveness. The manual will be updated periodically to reflect requirements for enhancement during the project implementation; such updates will be subject to Bank's review and no-objection. The manual will ensure that Bank's audit rights are inserted into the contracts funded by sub-loans, as well as the clauses on Fraud and Corruption.

It is to be noted that the above procedures are consistent with the ADB loan requirements which indicate the use of established private sector or commercial practices acceptable to ADB.

Procurement of Advisory Services to Support IIFF

7. **Consulting services procured by IIFF for its technical assistance needs include social/environmental monitoring, on-the-job advisory, training, financial and technical auditing, etc.** These consultant services are to be wholly financed by IIFF own funds and would be procured in accordance with the procurement procedures that will be developed for IIFF internal use.

B. Assessment of the agency's capacity to implement procurement and use of commercial practices in the country:

8. **At this stage, it is not possible to carry an assessment of the procurement capacity of neither IIFF nor any of the firms that may apply for sub-loans.** IIFF is still under establishment and there is still no specific pipeline for entities that will apply for funds.

The establishment of IIFF will take into consideration creating an adequate procurement function within IIFF. Its main responsibilities will be to review procurement arrangements proposed by entities applying for sub-loans; ensuring that these arrangements are in line with the commercial practices as outlined in the Operation Manual; review adequacy of proposed procurement plans for the sub-loans; assess capacity of entities to carry the procurement plans; monitor implementation of the procurement plans; provide capacity building to sub-loan recipients and lastly to update the procurement section in the Operations Manual as needed and agreed with the Bank. At this stage, the procurement function is being considered in the IIFF draft organizational chart as a procurement department led by a manager and including two staff. This may need to be revised at a later stage to fit the procurement function within an operational department/unit that would carry the overall assessment of the feasibility of proposed projects for sub-loans as well as monitoring implementation of approved ones. The staffing requirements should be flexible and include resources for high quality short term support as needed.

9. **It is expected that 20% of sub-loans may go to State Owned Enterprises (SOEs) which meet the eligibility criteria of being financially autonomous and operate on a commercial basis.** SOEs usually have detailed procurement procedures that are generally in line with the principles of the national procurement regulation (Kepress 80/2003). The procurement regulations for each SOE is issued by a decree from its President Director and based mainly on Kepress 80 requiring open competitive bidding process for most of their procurement. It differs from Kepress 80 by allowing some flexibility in higher level of thresholds for using procurement procedures other then open competitive bidding. For example, direct contracting is used under Kepress 80 up to a threshold of IDR 50 million (app. USD5, 000). Under SOE's procedures, the thresholds for this method is increased to the equivalent of USD 20,000 or USD 30,000 depending on the SOE. In the case of selection of consultants, recent capacity assessment carried by the Bank of two SOEs found that the selection methods used are Quality Based Selection (QBS), Quality and Cost Based Selection (QCBS) and Least Cost Selection (LCS) while, under Keppres 80/2003, besides these three methods as mentioned, Fixed Budget Selection (FBS) may also be used. It is to be noted that the implementation and procurement capacity in SOEs is usually better then in line ministries. In summary, the procurement procedures of these SOEs follow the principles of economy, efficiency and transparency. It will be possible for SOEs to follow commercial practices that will be outlined in the Operation Manual. However, this will depend on whether a SOE will be applying for a loan on their own or in a joint venture with a private firm. In the first case, even though the commercial practices are more flexible, the SOE may have to follow their own procedures of open competitive bidding depending on the thresholds used for different methods of procurement. In the latter, this would have to be assessed by IIFF on a case by case basis.

10. **This assessment is based on the Bank's experience** in working with SOEs and in particular on two recent capacity assessments carried for PT Pertamina Geothermal Energy (PGE), PT Perusahaan Listrik Negara (PLN) and an ongoing project with PT Perusahaan Gas Negara (PLN).

11. **In the private sector the commercial practices for procurement vary according to the type and size of firms**. In the oil and energy sector, it is quite normal to see developed procurement practices and capacity which ensure that procurement is carried economically and efficiently. This is usually the case for large firms or those which operate as affiliates or subsidiaries of international firms. Procurement procedures are normally documented and well

developed. These cover the whole procurement cycle from needs identification, vendor selection to contract execution. The procurement function is clearly identified , and a team is assigned for this. The firms have a career path for procurement staff as well as resources for development of the capacities of their staff on best practices and contractual aspects. Bidding is usually done on a limited competitive basis and the Request for Quotations are launched to a list of identified and qualified vendors. This list can be national or international depending on the nature of works, goods or services to be procured. Quotations are submitted by bidders at the same time and an evaluation committee (or subcommittees) carries the technical and commercial evaluation. Negotiations are usually held with the firm who is determined to be responsive and offering the best combination of price/technical/ownership cost factors favorable to the firm. Open tendering process is followed by some firms while others prequalify suppliers/contractors prior to requesting quotations.

12. **For medium size firms, or firms with no exposure to work with international affiliates, procurement practices are less developed.** Based on meetings with two commercial banks that lend to private sector developers, a representative of a major heavy equipment manufacturer that is a supplier to private sector developers, and two infrastructure projects developers; it seems that the procurement procedures in this segment of the market tend to be less formal with a limited number of companies having detailed and written procurement guidance. The main criteria for selection and awarding contracts is based on previous experiences with the contractors/suppliers (good quality, services, timely supplies, cost economics etc). Occasionally, limited tendering is invited from few reputed suppliers/contractors and the most suitable bidder is awarded the contract after negotiations. Open tendering process is followed in very limited situations.

13. **Since this is a Financial Intermediary Loan** and given the Project's specific financing arrangement, the implementing entities are not expected to implement their procurement using the Bank's traditional competitive methods, but mostly through commercial practices. However, entities still need to have reasonable knowledge of sound procurement practices. Therefore, some of the risks that may rise can be:

(i) lack of institutional capacity and specific organization and staffing for project/procurement implementation:

(ii) lack of knowledge and experience on competitive bidding, and excessive use of direct contracting/single source selection;

14. **Based on the above and the specific nature of procurement work required for the project, the procurement risk for the proposed project is rated as *"High"*.** To mitigate the procurement risks and to strengthen the project procurement implementation capacities, the following key actions are proposed for the project:

- Creating within IIFF a procurement function that will have responsibilities to assess the procurement management systems of the entities in which IIFF will provide sub-loans and monitoring the procurement, on a sample / high-value basis. of some of the major contracts which those enter into.
- Preparing a procurement section in the operational manual for guidance for IIFF staff and sub-loan recipients. This will be prepared based on simplified procedures that would be suitable for commercial practices. These procedures should provide the best practices of firms in the better performing segment of the market. All procurement under the project

will follow these procedures that would be acceptable and ensuring economy, efficiency and transparency.

- An internationally experienced consultant will be hired at IIFF's cost to assist/train IIFF procurement department/team and provide on the job training. This consultant can be recruited for the first 18 months of establishing IIFF with possible routine visits after that period to assess progress.
- Training will be provided by IIFF for sub-loan recipients on the procurement procedures applicable for their projects

15. **The preparation of an IIFF is currently being supported on an organizational structure that will have a clearly specified through a TA funded by AusAid.** This TA also is also supporting the establishment of a procurement department/team at IIFF. This is work in progress and will continue until the operation manual is ready and satisfactory to the IIFF and the Bank.

C. Procurement Plan

16. **For each sub-loan, the borrowing entity should prepare a detailed Procurement Plan for the implementation of its sub-project.** The format to be used will be included in the operation manual. The Procurement Plan will be made available on the IIFF website. This will be updated in agreement with IIFF at least annually to reflect the actual project implementation needs.

D. Bank Prior-Review and Frequency of Procurement Supervision

17. **Due to the nature of the project, no prior review will be conducted by the Bank.** IIFF will hire an independent private audit firm to conduct an annual audit which should cover technical, financial and procurement aspects of the sub-loans. The Bank will review and clear the TOR for this audit. The Bank will use the output of this audit to monitor the quality of procurement and compliance with the operational manual.

E. Details of the procurement arrangements involving international competition

Goods and Works and non-consulting services.

List of contract Packages which will be procured following ICB method:

No ICB contracts are expected at the time of project preparation.

Consulting Services.

List of Consulting Assignments with short-list of international firms:

No consulting contracts with shortlist of international firms are expected at the time of project preparation.

Annex 10: Financial Management Assessment

A. Executive Summary and Conclusion

1. **The project will be financed by an IBRD loan and implemented over four years.** The Government will provide these funds to the Indonesia Infrastructure Finance Facility (IIFF) through Sarana Multi Infrastruktur (SMI). The purpose of this project financial management assessment is to determine whether the financial management system of the implementing agencies have the capacity to produce timely, relevant and reliable financial information on project activities, and if the accounting systems for project expenditures and underlying internal controls are adequate to meet fiduciary objectives and allow the Bank to monitor compliance with agreed implementation procedures and appraise progress towards its objectives.

2. **The main financial management risks for the project are financial management system and staff capacity in SMI and the IIFF.** The main risks relate to whether the two institutions have sound financial management systems and adequate financial management staff. SMI was recently established on February 26, 2009, and has yet to develop a financial management system. The IIFF had yet to be established at the time of this assessment. A first draft of the financial management section of the operations manual - consisting of a general framework of the financial management department has been submitted to the Bank and has been reviewed. This draft will be enhanced and finalized in the Operations Manual prior to loan effectiveness.

3. **FM risk in SMI is likely to be lower than in the IIFF as SMI will act as the fund-channeling agency for the IIFF for the purposes of this project.** The IIFF will manage and use these funds to provide a variety of financial products and services to commercially viable infrastructure projects. Further assessment will be conducted after the IIFF has been established.

4. **The FM risks will be mitigated by** i) provision of technical assistance for the establishment of the SMI and IIFF; ii) provision of technical assistance to the IIFF for the recruitment of qualified staff — the IFC has provided grant financing for the retaining of an executive search firm to headhunt the initial team, and it is expected that the IFC, ADB, and DEG will nominate one member each to the IIFF Board of Commissioners; and iii) ongoing provision of technical assistance by AusAID to develop among others, the financial management section of the operations manual of IIFF and iv) adoption of operations manual by IIFF.

5. **Overall, the project financial management risk is assessed as being high before mitigation and substantial after mitigation**. This assessment has concluded that with the implementation of the action plan, the risks will be substantially mitigated, and the proposed financial management arrangements will satisfy the Bank's minimum requirements under OP/BP10.02, and be adequate to provide, with reasonable assurance, accurate and timely information on the status of the loan as required by the Bank. More details of the financial management assessment are given below.

B. Country Issues

6. **Based on the Country Financial Management Assessment**, Public Expenditure and Financial Accountability Report and other assessments/reports, there are major acknowledged

deficiencies in the Public Financial Management area that have been accepted by the government. Some of these deficiencies are:

- Inefficient budget formulation process;
- Fragmented cash management and government banking arrangements;
- Unreliable accounting and reporting systems;
- Lack of capacity in audit institutions;
- Poor salary and incentive structure, and lack of sanctions in the civil service;
- External audits are not risk-based and do not focus adequately on systemic issues.

7. **Recent public financial management reforms in Indonesia have been instituted as part of the broader macroeconomic stabilization reform agenda set out in the public financial management strategy 2001 and the Government White Paper of 2003.** The Indonesia public financial management reform agenda is led by the Government, with technical support being provided by many donors, including the World Bank through GFMRAP.

8. **Major progress in laying the foundations for public financial management reform** has been achieved to date, including the enactment of a new State Finance Law and Audit Law, and the introduction of revised government accounting standards.

9. **This project will only employ the government system** in respect of the flow of funds from MOF to SMI. The rest of the process will follow commercial business practices.

C. Project Objectives

10. **The proposed project has two overall objectives**: (i) strengthening and further developing the institutional framework of the financial sector to facilitate the financing of commercially viable infrastructure projects; thereby resulting in (ii) increased provision of private infrastructure in Indonesia. The net outcomes are expected to take the form of a more inviting investment climate, improved sustainability as regards growth, and more effective poverty reduction in the long term.

11. **The loan to GOI will be made available to the IIFF as subordinated debt.** The Bank, along with other development partners, will approve an operation s that will form the basis for IIFF's decision-making as regards specific projects that merit support and the instruments that it selects to provide such support. The Bank will not be involved in approving individual sub-projects that the IIFF chooses to support.

D. Strengths and Weaknesses

12. **The project has strengths and weaknesses in several areas. The project design has the following strengths:**

- Both agencies SMI and IIFF will follow commercial practices. The IIFF will operate as a commercial entity, with market-based rates and fees. It will respond to market demand, and adhere to international best practices on corporate governance, operational policies and risk management;
- Other development partners involved in this project include the ADB, IFC, AusAid, and DEG. All of these agencies have been involved since the commencement of the preparatory work for the establishment of the SMI and IIFF.

13. **The main weaknesses noted during the assessment are as follows:**

- SMI has only recently been established, while the IIFF has yet to be established. Financial management systems had yet to be developed for the two agencies at the time of the assessment.
- Qualified staff have yet to be recruited for the IIFF.

14. **The project's weaknesses may create some risks for project financial management.** However, the project includes several mechanisms to mitigate these risks. Among these are:

- Provision of technical assistance for establishment of SMI and the IIFF. Donors such as AusAID have provided grant financing for project preparatory work.
- Provision of technical assistance to the IIFF for the recruitment of qualified staff. The IFC has provided grant financing for the retaining of an executive search firm to headhunt the members of the startup team. It is expected that the IFC, ADB, and DEG will nominate one member each to the IIFF Board of Commissioners. FM key staff (CEO and CFO), will be appointed prior to effectiveness.
- Provision of technical assistance to develop FM section of the Operations Manual and the manual should be adopted prior to effectiveness.
- Computerized the FM system at IIFF's cost should be established four months after loan effectiveness.

E. Risk Assessment Summary

15. **A detailed analysis of the financial management risks arising from the country** situation, the proposed project entities, and specific project features and related internal controls was completed during the assessment, and is summarized below. These risks have been rated on a scale of *high, substantial, moderate and low*. The overall financial management risk is assessed as substantial before mitigation and moderate after mitigation provided that all mitigating measures are effectively implemented and the project is effectively supervised.

Issues	Risks	Summary Comments And Risk Mitigation	Residual Risks	Condition of Negotiations/of Effectiveness (Y/N?)
A. Inherent Risks				
Country Level				
1. Public Financial Management	H	Government recognizes existing weaknesses in public financial management and has several programs to improve the situation, including through Bank financed projects.	S	
Overall Country Risk	H		S	N

Issues	Risks	Summary Comments And Risk Mitigation	Residual Risks	Condition of Negotiations/of Effectiveness (Y/N?)
Entity Level				
1. Implementing Entity Organization *Status of the entity*	H	SMI was established on February 26, 2009 and is fully owned by the GOI. IIFF has not been established yet. Both agencies will operate and follow commercial practices. Donors have provided grant for the establishment of both agencies.	S	
Overall Entity Risk	H		S	
Project Level				
1. Project Complexity	H	GOI will provide funds to IIFF through SMI. IIFF will use these funds to provide a variety of financial products and services to commercially viable infrastructure projects. Potential recipients of the sub-loans have not been identified yet. TA Provision to develop the operation manual	S	
2. Financial management staff capacity. *Inadequacy of* financial management *staff*	H	Key staff have been recruited for SMI and a professional headhunter will be used to identify potential candidates for the IIFF.	S	Appointment CEO and CFO prior to effectiveness
Overall Project Risk	H		S	
B. Control Risk				
Budget *Delay in issuing and effectiveness of budget documents*	S	The loan will be incorporated in DIPA (government budget). Delay in issuing and effectiveness of DIPA may be minimized as the Satker (line unit) will be in Dit. Assets, MOF	M	

Issues	Risks	Summary Comments And Risk Mitigation	Residual Risks	Condition of Negotiations/of Effectiveness (Y/N?)
2. Accounting *Reliability of accounting system*	S	Systems had yet to be put in place at the time of the assessment. All transactions should be recorded in the accounting systems and included in the financial reports of both agencies. Both agencies will prepare separate sets of project financial reports that are suitable for project monitoring purposes.	M	Establishment of Integrated system, 4 months after effectiveness
3. Internal Control *Inadequate control system*	S	Both agencies will follow commercial practices, including as regards the development of internal control systems and establishment of internal audit function with TOR satisfactory to the Bank.	M	Adoption of the manual prior to effectiveness and establishment of internal audit function 4 months after effectiveness
4. Flow of Funds *Not used for intended purposes*	S	Flow of funds from MOF to SMI will follow the government system. The rest will follow commercial practices.	M	
5. Financial Reporting *Reliability and timeliness of financial reports*	S	Both agencies will submit quarterly project financial reports in a timely fashion. The annual financial statements of both agencies will include notes containing project financial information.	M	Establishment of Integrated system, 4 months after effectiveness
6. External Audit *Poor follow-up on audit findings*	M	SMI and IIFF will be audited by an independent reputable auditor that is acceptable to the Bank. The audit TORs will be in line with the agreed terms of reference.	L	
Overall Control Risk	S		M	
Overall Risk	H		S	

F. Institutional Arrangements

16. **A Project Management Unit (PMU) in DG Treasury will be established.** The PMU will have limited responsibility for processing and transferring loan funds to SMI. SMI was established on February 26, 2009, and is fully owned by the GOI. The IIFF has not been established yet. Both agencies will operate in line with normal commercial practices.

17. **The GOI will provide the funds to the IIFF through SMI (IIFF is the sole participating financial intermediary).** The IIFF will use these funds to provide a variety of financial products and services to commercially viable infrastructure projects. Key staffs have been recruited by SMI and professional headhunters will be used to identify potential candidates for the IIFF.

G. Accounting and Reporting

18. **All financial transactions will be recorded by the PMU, SMI and IIFF.** The PMU will employ the government accounting system, while SMI and the IIFF will follow commercial practices. SMI and the IIFF will prepare separate sets of project financial reports for project monitoring purposes.

19. **SMI will be responsible for preparing aggregate Interim Financial Reports (IFR)** and submitting these to the Bank on a quarterly basis in formats as agreed with the Bank. SMI and IIFF annual financial statements will include notes on project financial information.

H. Internal Control

20. **SMI and the IIFF will operate as commercial entities,** and will adhere to common practices as regards corporate governance, operating policies, financial management and internal control systems. SMI finalized its articles of association during the course of the assessment. It plans to have its basic financial management system and manual in place by June 2009. The key controls in the IIFF operations manual include:

- Organization Structure,
- TOR of Board of Directors and key positions one level below BOD,
- Rules that define relationships within the structure,
- Internal controls within the structure,
- Establishment of internal audit function,
- Corporate governance and,
- Code of ethics.

21. **The IIFF will adopt the operations manual being developed during the course of this assessment.** Adoption of the manual will be a condition for effectiveness. The government and development partners expect that the IFC, ADB, and DEG will nominate one member each and SMI will nominate two members to the IIFF Board of Commissioners.

I. Audit Arrangements

22. **SMI and IIFF will prepare annual financial statements which include notes on project financial information**. The auditing of these statements will be carried out by an independent reputable auditor that acceptable to the Bank. The audit report should be submitted

to the Bank no later than six months after the end of the fiscal year. The discussions are still on with MOF for the audit of SMI.

23. **The audit assignment will be in accordance with the agreed terms of reference.** It is expected that the external audit will go beyond merely providing an opinion on the accounts to include opinions on the internal control framework, compliance with the loan agreement and compliance with the operational manual.

J. Disbursement Arrangement

24. **The applicable disbursement methods include:** 1) Advance, 2) Reimbursement, and 3) Direct Payment as referred to in the WB Guidelines for projects dated May 1, 2006.

25. **In order to facilitate disbursements under the Advance method, PT.SMI will open a deposit account[27] in a commercial bank acceptable to the Bank.** The account will be denominated in Rupiah and will be solely used to finance eligible subproject loans expenditures. The ceiling of the advance to the account is fixed at $10 million. At the initial stage of the project, smaller advance may be deposited to the account, but should there be a need to have an advance beyond the applicable ceiling at later stage, PT.SMI should request to the Bank to increase the ceiling with justifications. IIFF will submit request for payments to PT.SMI against subproject loans and will be paid by PT.SMI from the deposit account. PT.SMI will ensure that the account will only be used to finance eligible subproject loans. PT.SMI will be responsible to report uses of funds in the account and to prepare the application for withdrawal for advances, duly approved by MOF DG Treasury (DSMI) and KPPN Jakarta VI before their submissions to the Bank. Applications for reporting of use of the funds would be supported by: (i) statement for the subproject loans' drawdown, (ii) reconciliation statement of account; and (iii) copy of bank account statement. Reporting of use of the account and application for an advance to the account may be submitted in a single application on monthly basis.

26. **PT.SMI may at its option, make payments against eligible subprojects' loan and request for reimbursement from the Bank by submitting the relevant application for withdrawal supported by** (i) statement for the subproject loan's drawdown and (ii) evidence of payments made. PT.SMI may also forward request for larger payments for subproject loans drawdown to the Bank for payment to be made directly to the subproject loan beneficiary by submitting application for withdrawal supported by records evidencing eligible subproject loans. These disbursement methods are subject to a minimum value of $100,000 equivalent per application.

27. **In line with the government procedures, the above three disbursement procedures will be categorized as "PL" (*pembayaran langsung*).** All application for withdrawal initiated by PT.SMI, will be submitted to MOF DG Treasury (Directorate SMI) for issuance of SPM-PP (payment order), and then to KPPN Jakarta VI for issuance of SP2D-PP (remittance order). These steps are to record the drawdown in the budget document (DIPA-PP) and to record the sub loan realization to PT.SMI. KPPN Jakarta VI will be authorized to sign the application for withdrawal for submission to the Bank.

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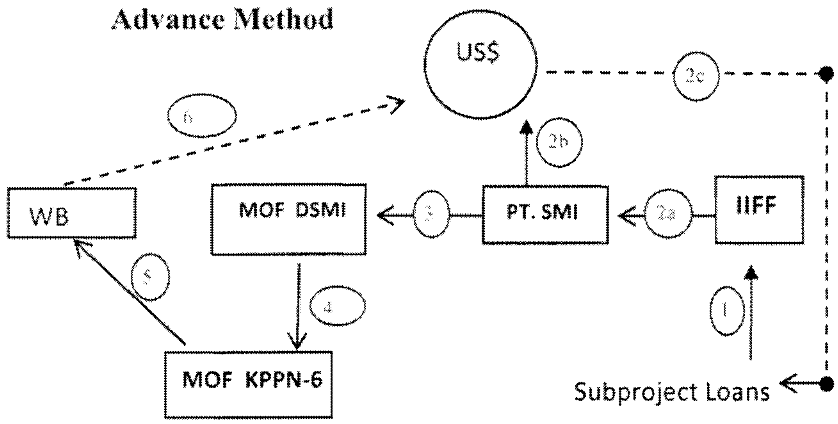
[27] This account is defined as the Designated Account referred to in Section 5 of the WB Disbursement Guidelines for Projects, May 1, 2006

Allocation of Loan proceeds

Category Description	Amount of Loan (US$)	% of expenditures to be financed
IIFF investments in sub-projects	100,000,000	100%
TOTAL	100,000,000	

K. Flow of Fund

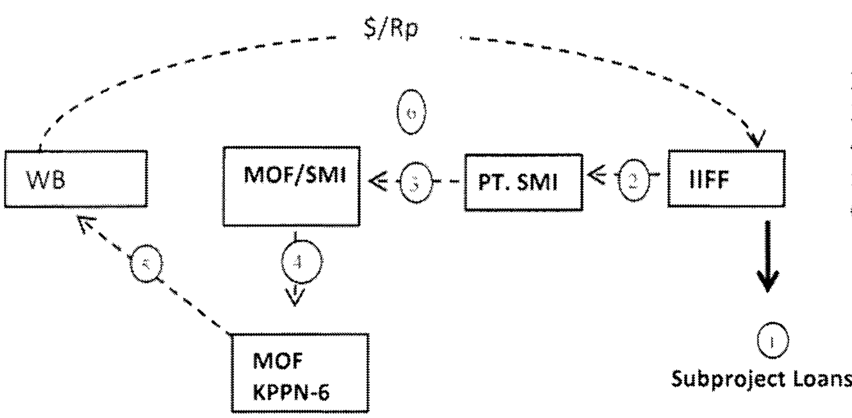
Advance Method



Details:

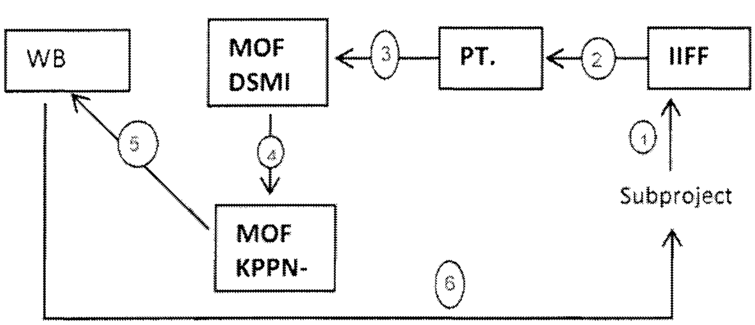
1. Subproject loan request from clients.
2a. IIFF endorsement/request.
2b. PT. SMI remittance order
2c. funds transfer to clients
3. Application for withdrawal
4. Issuance SPM
5. authorized signing
6. Replenishment to a/c

Reimbursement Method



Details:
1. Drawdown
2. Application for withdrawal
3. Endorsement
4. Issuance SPM
5. Authorized signing
6. Reimbursement to IIFF

Direct Payment



Details:
1. Request for drawdown
2. Application for withdrawal
3. Endorsement
4. Issuance SPM
5. authorized signing
6. Direct payment to clients

L. Supervision Plan

28. **Risk-based supervision of project financial management will be conducted.** This will involve a review of the project financial management system, including project expenditures, accounting, and reporting and internal control framework. Financial management supervision will be conducted by a financial management specialist and Bank consultants.

M. Action Plan

Action	Responsibility	Due Date
Draft Framework of the FM section of the Operations Manual	SMI	Reviewed prior to negotiations
Adoption of Final Operations Manual (OM) including the FM Section of the OM	IIFF	Prior to effectiveness
Appointment of CEO and CFO	IIFF	Prior to effectiveness
Integrated FM System	IIFF	4 months after effectiveness
Establishment of internal audit function, with TOR satisfactory to the Bank	IIFF	4 months after effectiveness

Annex 11: Governance Action Plan

1. **The proposed project aims to support the Government's efforts to establish a non-bank financial institution** – the Indonesian Infrastructure Finance facility (IIFF) - that will assist in the development of, as well as provide long-term local currency financing to, commercially viable infrastructure projects.

2. **A sound governance structure is key to the success of IIFF.** Substantial multi- and bi-lateral as well as private sector (domestic and international) equity participation will be the driver of sound governance. IIFF will adopt sound corporate governance practices to confirm its position as a credible institution in the eyes of all stakeholders. In addition, to improve transparency, IIFF will voluntarily comply with the listing requirements of the Indonesian Stock Exchange (IDX) from the outset, even though it is expected to be listed only in the medium-term. It is expected that this voluntary compliance will create IIFF transparancy level at the same as best practices level. In addition, being a non-bank financial institution, IIFF will be subject to the Indonesian regulatory requirements for such institutions with supervision being conducted by Bapepam-LK.

3. **Board representation by the equity investors will be critical** to ensuring that appropriate internal controls, risk management mechanisms including anti-corruption measures, and high quality human resources are adopted and implemented. IIFF will have a two tier board structure, i.e., the Board of Directors and the Board of Commissioners. The Board of Directors is responsible for the day to day management of the company and the Board of Commissioners is responsible for providing oversight function. It is expected that the IFC, ADB, and DEG will nominate one member each on the IIFF Board of Commissioners. To supplement the skills available to it, IIFF will induct a number of independent Commissioners who are highly reputed in areas such as law, accountancy/audit, economics, environmental and/or social issues, civil society organizations, etc. Such independent Commissioners, apart from providing credibility to IIFF and playing a vital role in corporate governance, will also make available to IIFF their skills and experience which will be invaluable.

4. **The Bank will undertake ongoing project supervision and policy discussions with the Government.** IFC's quarterly and annual supervision reports will provide detailed monitoring of operational performance information concerning the IIFF and its development impact, throughout the entire holding period of the IFC's equity stake.

5. **The project design recognizes that the infrastructure industry in Indonesia has high risk of corruption.** A study by the Commission for the Supervision of Business Competition (KPPU) finds that corruption risks in infrastructure are high, particularly in the water and sanitation, and transportation sectors. Corruption risks were driven not only by the government people side, but also by the contractors, consultants and respective associations as well as the structure of the industry itself. Corruption cases investigated by the enforcement authorities in electricity, oil and gas, and telecommunication sectors, show that corruption risk in those sectors is also high. To prevent the IIFF being tainted from corruption, appropriate mitigation measures need to be designed and implemented. Given that the IIFF would be a private company established under Indonesian Company Law and would operate in the Indonesian business environment, the measures will be designed accordingly. As a private business entity, governance and corruption prevention measures for IIFF will be incorporated in its Articles of Association (to the extent permitted by Indonesian law), Shareholders'

Agreement, and the Operations Manual (OM) that will include sections on Human Resources, Integrity Due Diligence, Procurement, Financial Management, Credit, Risk management, etc. and the OM will be adopted by the IIFF. Operations Manual is subject to the approval of the Bank. The Shareholders will also satisfy themselves regarding the Manual. Governance and corruption-related risk factors and mitigation measures are discussed in the table attached to this annex. Risks and mitigation measures concerning financial management and procurement are discussed in Annexes 9 and 10.

6. **The Bank has reviewed drafts of the subsidiary loan agreements between the Government and SMI, and the subordinated loan agreement between SMI and IIFF.** The Bank's loan will e become effective only after it has satisfied itself that these are acceptable. The subsidiary and subordinated loan agreements will contain undertakings by IIFF and SMI to ensure that all fiduciary and implementation undertakings made by the Government to the Bank are conditions of the use of the funds by IIFF and SMI.

7. **Given that IIFF is a private company, the Board of Commissioners (BOC) will be tasked with, among others, regularly reviewing the company risks and developing recommendations including the introduction of policies and procedures for risk mitigation which the BoD will be required to implement.** To execute the task, the BOC will be authorized to establish a risk management committee under its control comprising of people with relevant expertise. The risks considered by the risk management committee will include governance and corruption risks. The BOC recommendations will be addressed to the BOD aiming the BOD to take action for controling the risks, and to the Shareholders to take action towards the BOD should the BOD does not follow up the BOC recommendations. These provisions for the BOC will be incorporated into the relevant Bank and/or Shareholders' Agreements.

8. **IIFF's founding Shareholders will ensure that IIFF is subject to high standards of governance and institutes processes and systems for anti-corruption.** A Shareholders' agreement will be signed by all the shareholders – the ADB, IFC, DEG, and SMI. This agreement provides that the shareholders shall require IIFF not to conduct any "sanctionable" practices – which includes broad interpretations of corruption, collusion, nepotism, fraud etc. The shareholders agreement also states that IIFF shall maintain and comply with internal procedures and controls that follow national law and best international banking standards to prevent fraud, corruption, money laundering or other illegal purposes or practices. As considered necessary, the Bank and IFC will review relevant procedures to ensure these procedures are sufficient. The Shareholders' agreement also contains definitions of "Corrupt Practices", "Fraudulent Practices", "Coercive Practices", "Collusive Practices" and "Obstructive Practices" and contains references to compliance of IIFF with Indonesian law as well as requirements for the IIFF not to provide financial services to people or companies sanctioned by the United Nations Security Council or debarred by the World Bank Group - in line with the standards required by IFC for its equity investments. These definitions are broadly in line with the Bank's guidelines as well as Indonesian Anti Corruption Laws and other laws which define collusion and nepotism. The adoption of this Shareholders' agreement is an effectiveness condition for the Bank's loan.

9. **Sound management of credit, market, and operational risks is a critical function for IIFF.** The relatively high leverage of infrastructure projects requires close attention to risk management, all the more so when regulatory frameworks are still at an early stage.

Considering these risks, the Board of Commissioners (BOC) would be tasked with, among others, reviewing the company risks and developing recommendations including the introduction of policies and procedures for risk mitigation on a regular basis, which the BoD will be required to implement. To execute the task, the BOC would be authorized to establish committees under its control comprising people with relevant expertise. The risks considered will cover corruption risks. Governance mechanisms to address procurement, financial management, and environmental and social issues are addressed in the respective sections below dealing with these issues.

10. **The IIFF will have adequate mechanisms to isolate it from political pressures.** The Government has recently and repeatedly demonstrated its intention to ensure the operational independence of IIFF and that the strong presence of institutions such as the Bank Group – and others involved - would greatly help in the process. The GOI also showed its willingness that the BOD & BOC members selected are of a high calibre. The only party who will be able to influence them is the Shareholders. These provisions should be stated on the Shareholders Agreement.

11. **To ensure no conflicts of interest between the different functions IIFF will perform,** e.g. broad advice to the Government on contractual structures, project advisory, and project equity and debt financing, IIFF will create fire-walls between functions with potential conflict of interest to ensure that no employee involved in the project finance function simultaneously works on policy advisory or project development mandates. The teams involved in policy reform and project development will be discrete and separated from the teams involved in project finance operations, reporting to separate top level directors. The experience of IFC in separating advisory from financing roles is expected to be particularly relevant in implementing this approach.

12. **In line with best practice, the IIFF will conduct Integrity Due Diligence on each project that will be financed by any IIFF financial product.** The IDD will form part of IIFF's operational procedures for the consideration and evaluation of a potential project and be conducted by staff trained in performing such work. The IDD involves conducting research to identify adverse issues such as corruption involving prospective IIFF client firms and the principals of those firms, and monitoring IIFF's portfolio firms. Results of this IDD will assist in protecting IIFF from being involved with such firms, so such firms will not get any business opportunities from IIFF funded projects. Consideration of conducting business with those firms that have been previously identified as being linked to adverse issues will only be permitted when the firms have taken appropriate actions to remove the individuals involved in the corrupt or illegal practices and the firm has also taken demonstrable actions to prevent further reoccurrences. The IDD will also take into consideration civil society involvement in third party oversight for every project.

13. **Management and other staff of the IIFF will be bound by an agreed IIFF Code of Ethics** that acknowledges the importance of compliance to stated rules, the need to report any possible transgressions or concerns and acceptance of severe sanctions for failure to comply. Before being accepted as members of IIFF management/staff, individuals will be given an induction session where they must read the Code of Ethics that will include a description of sanctionable actions (including but not limited to corrupt practices) and thereafter sign a statement that they understand and will be bound by the Code of Ethics. As part of the Code of Ethics requirements, the BOD and BOC members as well as certain key positions will declare

their personal assets and income yearly. The declarations will be treated as confidential and will be made to the Board of Commissioners through the Head of Compliance. This provision will be included into the Shareholders Agreement.

14. **In the event that Bank funds are found to have been abused either by SMI or by IIFF, the Bank continues to retain the remedies that it has in its agreement with the Government**. As understood by GOI during preparation meetings with the Bank team, should corruption or fraud or other sanctionable practice involving Bank funds occur then the GOI would be required to refund any amounts involved to the Bank. In such cases, GOI may seek a refund from SMI which in turn may seek reimbursement from IIFF. In addition, the BOD should take appropriate action to sanction parties inside IIFF and announce publicly that IIFF would not have any business relationship with the involved outside parties for certain periods. The Risk Management Committee will report to any instances of suspected corruption, fraud or other sanctionable practice involving Bank funds to the BOC. The Shareholders should take appropriate action in regard to the BOD or BOC should they not implement these provisions properly. The Institutional Integrity Vice-Presidency of the World Bank retains the right to require an audit, request documents from IIFF, or conduct an investigation into any allegation of sanctionable practice involving IIFF. Such actions may occur in addition to any action taken by IIFF in respect of any allegations. The above provisions will be included in the Shareholders Agreement.

Governance Risk Analysis

Risk factors	*Description of risk*	*Rating[a] of risk*	*Mitigation measures*	*Rating[a] of residual risk*
Organization control risks	Control system and comprehensive governance system will depend on the IIFF sound organization structure with clearly defined roles and lines of accountability	M	IIFF will have a two tier board structure, i.e., the Board of Directors and the Board of Commissioners. The Board of Directors is responsible for the day to day management of the company and the Board of Commissioners is responsible for providing an oversight function. The IFC, ADB, and DEG will nominate one member each on the IIFF Board of Commissioners. IIFF also will induct independent Commissioners who are renowned professionals in areas such as law, accountancy/audit, economics (especially policy and regulatory reform), environmental and/or social issues, civil society organizations, etc. These organization structure requirements will be stated on the IIFF company Articles of Association or Shareholders Agreement which will clearly articulate the roles and level of accountability of the various actors.	L
Management Risks	The management of IIFF is still to be recruited. The success of IIFF will depend on its ability to recruit experienced finance/infrastructure professionals	M	This risk is mitigated by the commitment of all stakeholders to get the best candidates on the market. IFC has hired a professional recruitment firm. Highly skilled staff will be required to direct and maintain internationally competitive infrastructure financing and such skills will be sought through international searches for all senior management and board appointments International competitive salaries and benefits	L

Risk factors	*Description of risk*	*Rating[a] of risk*	*Mitigation measures*	*Rating[a] of residual risk*
			will be paid. These recruitment requirements will be stated on the IIFF company Articles of Association or Shareholders Agreement.	
Capture by Political Interest Risks	Politicians may see IIFF as an attractive vehicle to support particular interests or through which to extract favors.	M	The international best practice governance arrangements being initiated up-front in the shareholder agreements and the GOI commitment to allow fully commercial operations based upon international accepted standards are critical mitigants against this risk. In this regard GOI has committed to keep its shareholding below 30-40 percent, and will therefore always be a minority investor. The strong governance arrangements being put in place for IIFF and standards the shareholders will require IIFF to meet will be emphasized to mitigate any potential concerns about GOI involvement. 1. IIFF will voluntarily comply with the regulations prescribed by BAPPEPAM&LK and listing requirements of the IDX, particularly regulations regarding governance and transparency, even though IIFF has not been listed in the IDX. 2. Those commitments will be formulated on the IIFF company Articles of Association or Shareholders Agreement.	L
Integrity and transparency in project implementation	This risk arises from the differing procurement standards and competencies, and different levels of transparency followed by	H	The IIFF will finance only those projects that comply with its internal policies and guidelines, developed in consultation with the IIFF shareholders and approved by	M

Risk factors	*Description of risk*	*Rating[a] of risk*	*Mitigation measures*	*Rating[a] of residual risk*
	the various concessioning authorities that could be involved in the project, leading, for example, to inconsistent treatment of bidders, inappropriate rejection of bidders, bid rigging, etc.		the Bank. The IIFF will act as a signaling effect for the sector, helping to define in Indonesia the appropriate and bankable approach to procurement and project selection generally. These requirements and the need to establish internal policy and guidelines will be stated on the IIFF company Articles of Association or Shareholders Agreement.	
Unintentional involvement in a corruption risks	This risk arises when unintentionally the member of IIFF management or staff involves in any transaction which at the end tainted by corruption since they do not know exactly what constitutes as corruption	M	The IIFF will have an HR section in its Operations Manual – that will be approved by the Bank - with clear descriptions about what constitutes corruption, collusion and nepotism as defined by the World Bank's/IFC's guidelines and Indonesian Criminal Law. All IIFF management and staff will attend an induction session where they will read the relevant description of corruption and sign a statement that they understand it.	L

[a] Rating of risks on a four-point scale – High, Substantial, Modest, Low - according to the likelihood of occurrence and magnitude of potential adverse impact.

Annex 12: Economic and Financial Analysis

Economic and financial analyses

1. **As noted earlier, the state of Indonesia's poor infrastructure is widely accepted as a major constraint to accelerating growth and reducing poverty.** The Government has set ambitious targets for increasing infrastructure investment to reduce the constraints to growth and continues to develop a framework for private financing of infrastructure where risks can be appropriately shifted to the private sector, recognizing the economic and financial efficiencies that can be generated.

2. **Economic analysis of sub-projects to be financed by IIFF can only be undertaken after IIFF is established and it identifies a set of projects that it would support.** The OM will lay out a methodology for economic assessment of sub-projects by IIFF. The economic analysis of the sub-projects will attempt to quantify their costs and benefits, and measure the net contribution of these sub-projects to society at large. As an example, for any toll-road projects that IIFF may finance, some of the key benefits that such sub-projects are designed to provide include accommodating higher levels of traffic, reducing travel time, and lowering vehicle operating costs. Specifically, the benefits measured by the economic analysis included savings in vehicle operating costs (VOC), and a reduction in vehicle travel time (VOT) due to improved road conditions that would result in improved riding quality and higher travel speeds. At the same time, these sub-projects also impose real costs, including construction costs, routine maintenance cost during construction period, and environmental and social costs. The Economic Internal Rate of Return (EIRR) and the Economic Net Present Value (ENPV) will be estimated by lifecycle costs and benefits to society under the 'With' and 'Without' project scenarios. The Bank team will monitor such analysis by IIFF and the performance of sub-projects during project supervision.

3. **One set of key economic benefits of the Project, not quantified in the analysis, is that it will help develop a market for long-term local currency infrastructure financing.** The Project aims to enable IIFF to act as a catalyst for mobilizing such financing. IIFF can also help set benchmark rates for long-term infrastructure financing through tapping the domestic and international markets for longer tenor debt financing. IIFF is also expected to engage in new product development (e.g., domestic and foreign currency denominated interest rate swaps, partial credit guarantees, etc.), which should also assist the development of a domestic market for long-term infrastructure bonds. For infrastructure projects for which IIFF provides advisory services, better structuring and bankability would provide a net economic benefit to society in terms of better quality infrastructure projects, over and above the benefits of IIFF financing.

4. **The key driver for IIFF's financial projections is the build-up of its assets, mainly its loan book.** This poses a problem in as much as IIFF's asset growth is difficult to estimate purely on a trend projection because it is IIFF's mission to break that trend and bring about growth in Indonesia's infrastructure development. Therefore, two assessments of the market were conducted: (i) a top-down review which resulted in the identification of a pipeline of US$76 billion up to 2015; and (ii) a bottom-up review of Indonesia's infrastructure projects pipeline whereby details of projects were analyzed, sector by sector. This produced a more specific projects pipeline of US$38 billion for the period 2009 – 2011. Based on conservative approach, IIFF market share is estimated below 2.5%.For the time horizon beyond 2011, the base case assumes an annual growth in infrastructure funding demand of 5 %.

Projected Balance Sheet

Table 14 summarizes the base case of IIFF's balance sheet projections:

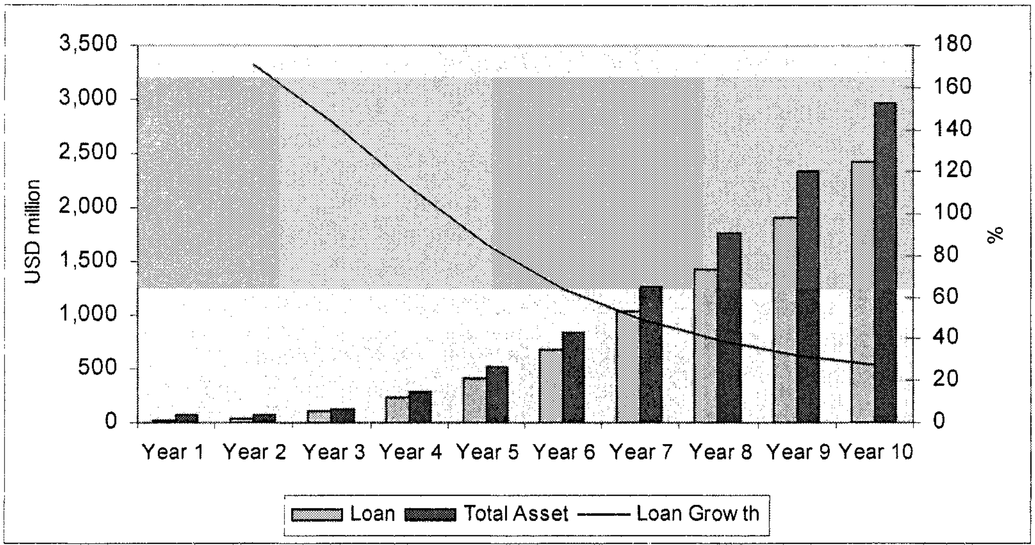
Table 14: Summary of Balance Sheet Projections

in US$ million:	Year 1	Year 2	Year 3	Year 5	Year 7	Year 10
Cash + Securities	48	30	17	66	163	382
Net Loans	16	44	106	417	1,028	2,423
Equity Investments	-	-	5	24	58	126
Total Assets	67	77	131	516	1,268	2,972
Market Borrowings	-	-	-	107	704	2,057
Subord. Debt	-	0.8	31	200	200	200
Convert. Debt	57	53	45	17	-	-
Total Equity	10	24	50	142	221	332
Other Liabilities + Reserve	(0.6)	(1.0)	4.9	49.1	142.5	383.7
Total Liabilities +Equity	67	77	131	516	1,268	2,972
CAR I	40%	40%	40%	35%	27%	22%
Gearing	6.8x	2.6x	1.5x	1.9x	2.8x	3.7x
Gross Non-Performing Asset	0%	1.5%	2%	4%	3.5%	3%

5. **Loan and Equity Portfolio**: In the initial years, .IIFF may acquiring some existing loans from other banks, refinancing loans on a more appropriate long-term basis for infrastructure projects which are already in operations, particularly where this may free up cash flow for sponsors willing to commit cash flow savings from the refinancing to new infrastructure investment. IIFF may also generate additional fee-based income thru developing advisory business for both GoI and project developers in the first three years. It is projected that the loan book will grow from US$16 million in year 1 to reach US$ 106 million in year 3. In year 4 and onwards, it is projected that IIFF's loan portfolio will grow in line with the increased market demand and extend its total outstanding loans to US$2.4 billion in year 10. Investments

in equity may be trailing the lending operations as IIFF staff will have to gain familiarity and expertise with Indonesia's infrastructure finance market before embarking on riskier equity investments. Figure 28 below shows the build-up of the projected loan portfolio and its growth (and total assets build-up).

Figure 28: Projected Asset and Loan Book Build-up (in US$ million)



6. **Asset Growth**: In line with the increasing pipeline, IIFF assets is projected to almost double in year 3, and later steady grow at the range of 27 to 49% from year 7 onwards when the total assets are projected to reach US$ 2.97 billion at year 10.

7. **Asset Quality**: NPA are projected to be low in the first two years of operations due to IIFF conservative approach in secured lending, i.e. 85% of IIFF financing will be in the form of senior term loan. Starting in Year 3, IIFF will consider investing small part of its equity stake in projects. The rationale behind this is that infrastructure investments are lumpy and one bad loan/unsuccessful equity investment can cause the NPA ratio to spike; some unfavorable investment decisions cannot be excluded in the early years when the portfolio remains small although IIFF's important position in Indonesian Infrastructure in its early years should allow it to be highly selective. It is recognized however that the infrastructure financing market will be a partly untested field.

8. **Equity/Leverage**: Starting with a seed capital of US$10 million as required by the Infrastructure Financing Company's regulation, IIFF 's total equity is projected to reach US$50 million in year 3 and US$142 million in year 5. As IIFF's asset base will grow, shareholders will continue to subscribe to new rights issues to support IIFF's growth and maintain a conservative capital structure. While the CAR I is projected to stay at 40% in the first three years, IIFF will steadily maintain its CAR position above 22% level. The projected gearing ratio (total debt/total net worth) will be relatively high in year 1 at 6.8x, but the gearing ratio will drop quickly as the loan book grows, equity rises, and the CAR I needs to be maintained at a conservative level. Most of the time, the gearing will hover at the range of 1.5 to 3.7x . The logic for that is that IIFF will be able to handle a higher gearing and lower CAR I after building sufficient experience and having created a track record for itself.

9. **Funding**: In its initial years, IIFF will have two strong funding tools at its disposal; US$ 200 million in subordinated loans from IBRD and ADB, and SMI's convertible debt. It is

projected that the convertible debt will only be fully converted into equity by the end of year 6. The subordinated debt will gradually be drawn down as needed, and the full draw-down is projected for year 5. These three funding instruments will secure IIFF from raising external funding sources in its early years of operations when its risk profile is higher. Not only are these instruments attractively priced but they also allow IIFF to establish itself a name in the market before looking for third party funding. The savings from these two funding sources are quite considerable and will ease any pressure on IIFF's funding side in the early operational phase.

Projected Income Statement

A summary of IIFF's projected income statement is shown in Table 15 below:

Table 15: Summary of Income Statement Projections

in US$ million:	Year 1	Year 2	Year 3	Year 5	Year 7	Year 10
Interest Income from Loans	1.01	5.12	13.12	56.95	151.90	383.17.
Total Interest Income	2.51	7.43	14.83	61.61	164.35	414.47
Net Interest Income	-0.48	1.88	7.71	27.85	64.74	140.89
Profit from Equity Sales	0	0	0	0	0	6.42
Income from Advisory Services	0.28	0.62	1.14	3.52	4.93	4.93
Operating Expenses	1.66	2.86	2.08	2.78	7.40	18.58
Profit before Taxes	-1.97	-0.90	5.82	27.85	62.11	133.84
Profit after Taxes	-1.97	-0.90	4.07	19.50	43.48	93.69
Net Interest Margin	-1.5%	2.7%	7.9%	7.5 %	6.5%	5.6%
RoA	-5.92%	-1.26%	3.92%	4.91%	4.11%	3.53%
RoE	-47.21%	-6.17%	11.25%	14.64%	14.52%	16.14%

10. **Interest Income**: While minimal in the first few years, interest income is projected to grow strongly in line with the increase in the loan portfolio. Interest income from loans will represent more than 90% of total interest income (except in the first two years),. The net interest margin is weak in the first year as the loan portfolio remains small. As IIFF's capital is not fully directed towards lending, some of the capital will be invested in short-term instruments with lower rates in year 1. However, along with the growing of IIFF loan portfolio in year 2, the net interest margin reaches a comfortable 8.2% level in year 4. In year 5, the net interest margin decreases as a consequence of IIFF effort in raising more expensive funding from market to support the loan book growth.

11. **Advisory Fees**: Although advisory services will be a critical area of focus in the early years because of the need to help create an infrastructure pipeline, revenues generated from this activity are expected to be small as IIFF establishes its value in the market. Consulting for GoI entities may generate only limited revenues even though it may play an essential role in generating bankable projects. It is anticipated that some of the remuneration from GoI consulting could be paid through donor-supported programs. Because of this, advisory income will start at a low US$280,000 and increase to US$620,000 and US$1.14 million in year 2 and 3, respectively. Beyond year 3, it is assumed that IIFF has the capacity to obtain advisory contracts from private-sector developers that boosts its advisory income.

12. **Profitability**: Measured as RoA, profitability is strongly correlated with the level of the net interest margin. Profitability reaches its peak at 5.28% in year 4 and gradually steady at level above 3.5 % in the following year. Meanwhile, RoEs track RoAs with a multiplier of 2.9 – 3 x up to year 6, but as IIFF's gearing increases, the RoEs rise much stronger and reaches a 4.6x multiplier to RoA in year 10.

13. **The base case projects an IRR of 15.4%, which is 6.9% above the cost of IFC's equity.** This can be considered a fairly good outcome since a conservative base case is presented here to reflect some of the uncertainties in the market better. Apart from the base case, an up-case and a down-case scenario were also run to test the Project's resilience. Table 16 below summarizes the key variables which were adjusted for the sensitivity analysis:

Table 16: Sensitivity Analysis

Dimensions:	Base Case:	Up Case:	Down Case:
Growth of infrastructure demand	5% p.a.	8% p.a.	3% p.a.
NPA ratio	4% peak and decreasing to 3.0%	Starting at 1% and increasing to 3%	6% peak and decreasing to 4.8%
Annualized return on equity sold	10%	20%	7.5%
Advisory income	US$280K (year 1); US$620K (year 2); US$1.14 mn (year 3); then in line with demand growth	US$280K (year 1); US$840K (year 2); US$1.69 mn (year 3); then in line with demand growth	US$280K (year 1); US$420K (year 2); US$630K (year 3); then in line with demand growth
*Interest rates on loans**	- 1% on all loan rates	-.-	-1.5% on all loan rates
Loan portfolio growth	US$16 mn (year 1); US$44 mn (year 2); US$108 mn (year 3); then in line with demand growth	US$29.5 mn (year 1); US$97.9 mn (year 2); US$244 mn (year 3); then in line with demand growth	US$16 mn (year 1); US$39 mn (year 2); US$90 mn (year 3); US$167 mn (year 4); US$265 mn (year 5); then in line with demand growth
Risk Weighting of Loans	All 100%	Senior loans, refinance loans and take-out loans at 50%; rest of loans at 100%	All 100%

14. **The IRR of the three cases is as follows:**

Base Case	**=**	**15.4%**
Up Case	**=**	**18.6%**
Down Case	**=**	**13.3%**

15. **IIFF's profitability is most sensitive to interest margin changes and then to asset growth.** However, the sensitivity analysis has shown that even under market conditions where demand for infrastructure financing and advisory services is not as strong as expected, and therefore revenues will fall short of expectations, IIFF will be able to achieve an acceptable financial performance.

Indonesian Infrastructure Finance Facility (IIFF) - Financial Projections
Projected Profit & Loss Accounts (USD Mn)

Profit & Loss Account	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Interest Income on Loans	1.01	5.12	13.12	29.32	56.95	97.80	151.90	218.15	295.54	383.17
Interest Income on Cash & Bank Balances	1.27	1.97	0.85	0.48	0.93	1.60	2.49	3.58	4.84	6.26
Interest Income on Marketable Securities	0.09	0.33	0.85	1.92	3.73	6.41	9.96	14.30	19.35	25.04
Total Interest Income	**2.37**	**7.43**	**14.83**	**31.72**	**61.61**	**105.81**	**164.35**	**236.02**	**319.73**	**414.47**
Interest Paid on Subordinated Debt	0.00	0.06	2.23	11.95	23.77	28.00	28.00	28.00	28.00	28.00
Interest Paid on Convertible Debt	2.85	5.49	4.89	4.01	2.63	0.87	0.00	0.00	0.00	0.00
Interest Paid on Market Borrowings	0.00	0.00	0.00	0.00	7.36	30.51	71.61	123.74	179.53	245.58
Total Interest Paid	**2.85**	**5.54**	**7.12**	**15.95**	**33.76**	**59.38**	**99.61**	**151.74**	**207.53**	**273.58**
Net Interest Income	**(0.48)**	**1.88**	**7.71**	**15.76**	**27.85**	**46.43**	**64.74**	**84.29**	**112.19**	**140.89**
Profit on Sale of Equity Investments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.40	4.13	6.42
Guarantee Fees	0.01	0.04	0.11	0.25	0.48	0.83	1.29	1.85	2.50	3.24
Income from Advisory Services	0.28	0.62	1.14	2.46	3.52	4.93	4.93	4.93	4.93	4.93
Fee Income from Arrangement of Funds	0.00	0.00	0.00	3.03	3.18	4.01	4.21	5.16	5.42	5.69
Total Revenue Net of Interest Paid	**(0.18)**	**2.55**	**8.96**	**21.51**	**35.04**	**56.20**	**75.17**	**97.62**	**129.17**	**161.17**
Operating Expenses	1.66	2.86	2.08	2.05	2.78	4.77	7.40	10.62	14.36	18.58
Depreciation	0.13	0.26	0.29	0.32	0.35	0.38	0.42	0.47	0.51	0.56
Provision for losses on funds deployed	0.00	0.33	0.78	3.65	4.05	4.96	5.24	5.98	5.07	8.18
Profit Before Tax (PBT)	**(1.97)**	**(0.90)**	**5.82**	**15.49**	**27.85**	**46.08**	**62.11**	**80.56**	**109.23**	**133.84**
Tax	0.00	0.00	1.75	4.65	8.36	13.83	18.63	24.17	32.77	40.15
Profit After Tax (PAT)	(1.97)	(0.90)	4.07	10.84	19.50	32.26	43.48	56.39	76.46	93.69
Dividend Payout	0.00	0.00	0.00	0.54	0.97	3.23	4.35	8.46	11.47	18.74
Profit Transferred to reserves	**(1.97)**	**(0.90)**	**4.07**	**10.30**	**18.52**	**29.03**	**39.13**	**47.93**	**64.99**	**74.95**

Sources : CRISIL Risk and Infrastructure Solutions, Ltd.

Indonesian Infrastructure Finance Facility (IIFF) - Financial Projections
Projected Balance Sheet (USD Mn)

ASSETS	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Loans	16.1	43.6	105.9	225.4	416.9	686.3	1,028.4	1,435.0	1,902.1	2,423.2
Equity investments in infrastructure projects	0.0	0.0	4.6	12.3	23.6	38.6	57.8	79.2	101.7	126.2
Marketable Securities	1.6	4.4	11.1	23.8	44.0	72.5	108.6	151.4	200.4	254.9
Gross Block - Fixed Assets	2.5	2.8	3.0	3.3	3.7	4.0	4.4	4.9	5.4	5.9
Less. Accumulated Depreciation	0.1	0.4	0.7	1.0	1.3	1.7	2.2	2.6	3.1	3.7
Net Block - Fixed Assets	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.2	2.2
Other Current Assets	0.2	0.7	1.7	3.6	6.6	10.9	16.3	22.7	30.1	38.2
Cash & Bank Balances	46.2	25.5	5.5	11.9	22.0	36.2	54.3	75.7	100.2	127.5
Total Assets:	**66.6**	**76.5**	**131.1**	**279.3**	**515.5**	**846.8**	**1,267.7**	**1,766.3**	**2,336.6**	**2,972.3**
LIABILITIES										
Equity Capital:										
Committed by initial shareholders	10.3	23.9	50.2	82.6	142.2	200.0	200.0	200.0	200.0	200.0
Additional equity infused through IPO/private placement	0.0	0.0	0.0	0.0	0.0	20.8	20.8	65.0	131.9	131.9
Total Equity Capital:	**10.3**	**23.9**	**50.2**	**82.6**	**142.2**	**220.8**	**220.8**	**265.0**	**331.9**	**331.9**
Reserves	**(2.0)**	**(2.9)**	**1.2**	**11.5**	**30.0**	**59.1**	**98.2**	**146.1**	**211.1**	**286.1**
Net Worth	**8.4**	**21.0**	**51.4**	**94.1**	**172.2**	**279.8**	**319.0**	**411.1**	**543.0**	**617.9**
Subordinated Debt from GoI	0.0	0.8	31.0	139.6	200.0	200.0	200.0	200.0	200.0	200.0
Convertible Debt - GoI's equity commitment	56.9	52.8	44.9	35.2	17.3	0.0	0.0	0.0	0.0	0.0
Market borrowings	0.0	0.0	0.0	0.0	106.8	336.3	704.4	1,094.9	1,516.9	2,056.7
Current Liabilities	1.3	1.5	2.6	5.6	10.3	16.9	25.4	35.3	46.7	59.4
Provision for losses on funds deployed	0.0	0.3	1.1	4.8	8.8	13.8	19.0	25.0	30.1	38.2
Total Liabilities	**66.6**	**76.5**	**131.1**	**279.3**	**515.5**	**846.8**	**1,267.7**	**1,766.3**	**2,336.6**	**2,972.3**

Sources : CRISIL Risk and Infrastructure Solutions, Ltd.

Indonesian Infrastructure Finance Facility (IIFF) - Financial Projections
Projected Cash Flows (USD Mn)

CASH FLOW	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
OPERATIONS										
PAT	-2.0	-0.9	4.1	10.8	19.5	32.3	43.5	56.4	76.5	93.7
Depreciation	0.1	0.3	0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.6
Loss Provisions	0.0	0.3	0.8	3.6	4.1	5.0	5.2	6.0	5.1	8.2
Change in Current Assets	-0.2	-0.4	-1.0	-1.9	-3.0	-4.3	-5.4	-6.4	-7.3	-8.2
Change in Current Liabilities	1.3	0.2	1.1	3.0	4.7	6.6	8.4	10.0	11.4	12.7
A) Net Cash from Operations	**-0.8**	**-0.5**	**5.2**	**15.9**	**25.6**	**40.0**	**52.1**	**66.4**	**86.1**	**107.0**
INVESTING										
Investment in Fixed Assets	2.5	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.5	0.5
Investment in Marketable Securities	1.6	2.7	6.7	12.7	20.3	28.4	36.1	42.8	49.0	54.6
B) Net Cash from Investing	**-4.1**	**-3.0**	**-7.0**	**-13.0**	**-20.6**	**-28.8**	**-36.5**	**-43.2**	**-49.4**	**-55.1**
FINANCING										
Equity Infusion	10.3	13.5	26.4	32.4	59.5	78.6	0.0	44.2	66.9	0.0
Increase/Decrease in Subordinated Debt from GoI	0.0	0.8	30.2	108.6	60.4	0.0	0.0	0.0	0.0	0.0
Increase/Decrease in Convertible Debt	56.9	-4.1	-7.9	-9.7	-17.9	-17.3	0.0	0.0	0.0	0.0
Increase/Decrease in Market Borrowings	0.0	0.0	0.0	0.0	106.8	229.4	368.1	390.5	422.0	539.8
Change in Loan Portfolio	16.1	27.5	62.3	119.5	191.5	269.4	342.1	406.6	467.1	521.1
Change in Portfolio of Equity Investments	0.0	0.0	4.6	7.8	11.2	15.0	19.2	21.4	22.5	24.5
Dividend Paid	0.0	0.0	0.0	0.5	1.0	3.2	4.3	8.5	11.5	18.7
C) Net Cash from Financing Activities	**51.1**	**-17.2**	**-18.2**	**3.5**	**5.2**	**3.1**	**2.5**	**-1.7**	**-12.2**	**-24.6**
Net Change in Cash (A+B+C)	**46.2**	**-20.7**	**-20.0**	**6.4**	**10.1**	**14.2**	**18.1**	**21.4**	**24.5**	**27.3**
Opening Cash Balance as per BS	0.0	46.2	25.5	5.5	11.9	22.0	36.2	54.3	75.7	100.2
Closing Cash Balance as per BS	46.2	25.5	5.5	11.9	22.0	36.2	54.3	75.7	100.2	127.5
Change in Cash Balance as per BS	46.2	-20.7	-20.0	6.4	10.1	14.2	18.1	21.4	24.5	27.3

Sources : CRISIL Risk and Infrastructure Solutions, Ltd.

Indonesian Infrastructure Finance Facility (IIFF) - Financial Projections
Selected Ratios

Ratios	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Gearing (Total Debt/Networth)	6 8	2 6	1.5	1 9	1 9	1 9	2.8	3 1	3 2	3 7
Capital Adequacy (Tier I)	40%	40%	40%	35%	35%	35%	27%	25%	25%	22%
Capital Adequacy (Tier II)	0%	2%	24%	52%	41%	25%	17%	12%	9%	7%
Total Capital Adequacy	40%	42%	64%	87%	76%	60%	44%	37%	34%	30%
Projected growth in loan portfolio	N A.	170%	143%	113%	85%	65%	50%	40%	33%	27%
Projected growth in interest income	N.A.	213%	100%	114%	94%	72%	55%	44%	35%	30%
Total Earning Assets (Incl Cash but excluding equity	64 0	73 5	122.5	261 1	483 0	795 0	1191 4	1662 2	2202.7	2805 6
Yield on Earning Assets	7.4%	10 8%	15 1%	16 5%	16.6%	16 6%	16 5%	16 5%	16 5%	16 6%
Net Interest Margin (NIM)	-1 5%	2 7%	7.9%	8 2%	7 5%	7.3%	6 5%	5 9%	5 8%	5.6%
Return on Assets (RoA)	-5 92%	-1 26%	3.92%	5.28%	4 91%	4 74%	4.11%	3 72%	3 73%	3 53%
Return on Equity (RoE)	-47.21%	-6 17%	11.25%	14 90%	14.64%	14 27%	14.52%	15.45%	16.03%	16.14%

Sources CRISIL Risk and Infrastructure Solutions, Ltd

ANNEX 13: APPROACH TO ENVIRONMENTAL AND SOCIAL SAFEGUARDS

A. Project Objectives

1. **The objective of the Project is to strengthen and further develop the institutional framework of the financial sector to facilitate financing of commercially viable infrastructure projects and thereby increase provision of private infrastructure in Indonesia.** The IIFF is expected to achieve the objective by building the necessary capacity and skills, and providing long-term financing, innovative financial products, and advisory services. The IIFF's ultimate objective is to increase the provision of infrastructure in Indonesia to support a more inviting investment climate, sustained growth, and poverty reduction in the long-term.

2. **The IIFF is a non-bank private financing institution that will borrow from the local debt market and lend to commercially viable infrastructure projects**. In its initial establishment, its fund sources will come from the ADB and IBRD loans, and from IFC, DEG, ADB and the GoI equities.

3. **The IIFF's mandate will be flexible, to permit investments in infrastructure on a commercial basis.** In the beginning, the fund likely will focus on sectors that put forward projects on a commercial basis to attract private sector investments. The sectors that IIFF will have under its investment mandate will include: energy (including power generation, transmission and distribution), water and sanitation, transportation (including roads, rail, ports and airports), industrial and commercial infrastructure sector, and telecommunications.

B. Project Component and Financial Products

4. **The project will have two components**: an investment loan to the Borrower that will be made available to IIFF as subordinated debt by the Borrower and IFC's investment. The Bank and IFC – along with other development partners involved in the project – will approve an Operations Manual (OM) that will form the basis for IIFF's selection process regarding specific projects to support and the financial instruments through which to provide such support. The Bank will not be involved in approving individual subprojects that IIFF chooses to support, provided that the Environmental and Social Unit in the IIFF has sufficient capacity to ensure that the IIFF's environmental and social policies will be met. However, the Bank and IFC will review the implementation of subprojects to ensure that the safeguard policies are properly followed.

5. **In its initial operation, the IIFF will focus on the following sectors:** (i) energy; (ii) water and sanitation; (iii) transportation; and (iv) industrial and commercial infrastructure. Taking into account that Indonesia's private infrastructure program is still in its infancy, and the fact that IIFF is itself expected to play a significant role in development of the pipeline going forward, the Bank team has deliberately assumed a slow growth of the balance sheet of IIFF. The Bank's loan is expected to be fully disbursed over a four-year period (2009-2012). IFC's equity investment is expected to be made on a 5 year period.

6. **IIFF will have three main financial product categories:**

- Fee based products provide fee income to IIFF (for e.g.: for its advisory services) and do not involve any disbursement of IIFF funds.
- Fund based products (for e.g.: senior debt, subordinated debt, mezzanine funding, equity investment, bridge finance, refinancing, securitization) do involve actual disbursement of Bank (through IIFF) funds. The first five categories - senior debt,

subordinated debt, mezzanine funding, equity investment, bridge finance - all involve financing for new infrastructure. The final two categories (refinancing and securitization) involve raising financing on the basis of existing infrastructure (effectively as collateral), typically for the purpose of building new infrastructure.

- Non-fund based products - such as guarantees - involve contingent disbursement of Bank funds (through IIFF). If a sub-project to which IIFF has a provided a guarantee defaults on its loan obligations to another financial institution or other investors, only then is IIFF required to meet the subprojects' obligations instead of the sub-project. Therefore, this is a contingent disbursement of Bank funds. However, since there is the ex-post possibility that Bank funds may be disbursed, ex-ante, the same set of safeguard requirements as for fund-based products must apply.

C. Types of Subprojects According to the Level of Preparedness

7. **IIFF will offer different financial products and will consider for subprojects with different levels of preparedness or readiness for implementation.** There will be four types of subprojects, which will require different types of review procedures:

- Type 1 – Subprojects in the early stages of preparation (with sites that have not been selected and design options that are still open): The IIFF client will prepare and disclose all Environmental Assessment (EA) documents (EIA, EMP, SIA, RAP, IPP, etc.) prior to the approval of the sub-project by IIFF.
- Type 2 – Subprojects that have been fully prepared (where construction bids have been invited): IIFF will review the EA documents that are available and will ask its clients to supplement them or develop new ones. All required documents must be disclosed prior to subproject approval.
- Type 3 – Subprojects under construction or with facilities that have already been constructed: IIFF will carry out a due diligence to confirm that: (a) the subproject is in compliance with all applicable national environmental and social laws and regulations; (b) there are no reputational risks for the IIFF and the World Bank Group (WBG); and (c) there are no legacy issues or no pending legal disputes or liabilities. Based on the findings of such an assessment, the IIF will ask its clients to implement remedial measures, if needed, or to mitigate potential reputational risks or to address legacy issues or liabilities.
- Type 4 – Fee-based advisory services: The ESSF must include procedures to ensure that all fee-based advisory services are provided in a manner that are consistent with the objectives of IIFF's policies and that do not create reputational risks for the WBG.

D. Objective of the Environmental and Social Safeguards Framework (ESSF)

8. **The purpose of the ESSF is to provide the IIFF**, particularly the Environmental and Social Unit within its organizational structure, a set of policies and guidelines that will assist them in the screening, appraisal and supervision of the environmental and social aspects of subprojects.

9. **The Framework outlines** (1) the WBG policies that will apply to subprojects supported by IIFF and (2) the implementation arrangements that will be put in place to ensure that these policies are implemented successfully and that subprojects meet all the applicable requirements of WBG as well as Indonesian laws and regulations.

10. **The IIFF will develop detailed procedures for the environmental and social review of subprojects.** These procedures, which will be integrated into IIFF's Operations Manual, will cover subproject screening, appraisal and supervision.

E. Applicable Policies

11. **It is not possible to determine prior to project implementation the various activities for which loan funds will be requested.** The financing is for medium and large size subprojects that meet certain eligibility criteria.

12. **IIFF, as a Financial Intermediary (FI) supported by both the World Bank and the IFC, will finance mostly *private sector* subprojects.** For this reason, the ESSF will use the IFC's Performance Standards (PSs) as the principal set of standards, with the provision that the final ESSF will reconcile the differences between the PSs and the WB policies by following the guidance provided in the document "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC and/or MIGA", dated January 21, 2009.

13. **The Operations Manual is being developed taking into account:**

- Indonesian laws and regulations;
- the eight Performance Standards (PS) of the IFC (PS 1: Social and Environmental Assessment and Management System; PS 2: Labor and Working Conditions; PS 3: Pollution Prevention and Abatement; PS 4: Community Health, Safety and Security; PS 5: Land Acquisition and Involuntary Resettlement; PS 6: Biodiversity Conservation and Sustainable Natural Resource Management; PS 7: Indigenous Peoples; and PS 8: Cultural Heritage);
- the seven World Bank Safeguard Policies that could be triggered by IIFF's subprojects (Environmental Assessment (OP/BP 4.01); Natural Habitats (OP/BP 4.04); Cultural Property (OP 4.11); Involuntary Resettlement (OP/BP 4.12); Indigenous Peoples (OP 4.10); Forests (OP/BP 4.36); and Safety of Dams (OP/BP 4.37); and
- the guidance provided in the document "Environment and Social Policy and Procedural Guidelines for Projects Financed Jointly by Bank, IFC and/or MIGA", dated January 21, 2009, to resolve any differences between IFC standards and Bank policy.

14. **IIFF will follow one set of standards, as specified in its ESSF and Operations Manual**.

F. Environmental Screening

15. **Each subproject will be screened to determine the appropriate extent and type of EA**. An environmental category will be assigned to the subproject, depending on the type, location, sensitivity, and scale of the subproject and the nature and magnitude of its potential environmental impacts. The screening process will also determine the scope of the safeguards instruments (e.g. EA, RAP) to be prepared.

16. **Infrastructure investment subprojects** (Types 1, 2 and 3) under this project are likely to have moderate to significant environmental and social impacts; they will be Category A or B subprojects under World Bank OP 4.12 on Environmental Assessment and IFC's Procedures for the Environmental and Social Review of Projects). Subprojects that involve fee-based advisory services (Type 4) will be assigned Category C.

G. Implementation Arrangements

17. **The procedures to be followed for each type will be defined in the Operations Manual, currently under preparation.** The OM – satisfactory to the WBG – will be prepared before loan effectiveness. The OM will contain procedures for screening subprojects and for ensuring that all project-associated adverse impacts are identified, effectively mitigated, and monitored.

18. **The project OM will lead to the establishment of IIFF's Environmental and Social Management System (ESMS).** An Environmental and Social Unit will be created under IIFF's organizational structure. This unit will include environmental and social specialists.

19. **The OM will contain all the necessary procedures to ensure that subprojects meet IFC's PS and WB Safeguard Policies.** The procedures will cover the following aspects:

- environmental screening and assignment of environmental category;
- identification of the social and environmental impacts and risks of subprojects;
- assessment and management of subproject impacts, including impacts on natural habitats, forests, and safety of dams, as applicable;
- consultation and disclosure requirements for each type of subproject, consistent with Indonesian regulations and WBG policies;
- land acquisition and resettlement, including procedures to compensate and rehabilitate affected persons;
- Indigenous Peoples, including procedures for free, prior and informed consultations; and
- review of EA documents and the capacity of IIFF's clients to manage environmental and social issues.

20. **The OM will include an Indigenous Peoples Planning Framework (IPPF) and a Resettlement Policy Framework (RPF)**, in compliance with the requirements of OP 4.10 and OP 4.12, and consistent with the requirements of PS5 and PS7. Preliminary versions of these documents are included in the Attachments 1 and 2 of the Draft ESSF.

H. Consultation and Disclosure of ESSF

21. **The current draft of the ESSF was developed on the basis of ADB-approved Safeguards Planning Document,** which was subject to several rounds of consultations and disclosed locally and at the ADB's Website in English language. This draft was discussed with the project stakeholders, including participating development partners.

22. **The environmental and social policies adopted in the current draft of the ESSF have been discussed among the key project stakeholders**, including IFC, the Bank, the ADB and the Borrower (Directorate General of State Assets). It has been agreed that the IIFF will have one common ESSF that complies with the environmental and social policies of all the parties that will finance IIFF. The current draft of the ESSF will be updated after additional consultations are carried out with key stakeholders, including civil society. The final version of the ESSF, which will be prepared before loan effectiveness, will be disclosed locally and at Bank's InfoShop. This final version will be the basis for the environmental and social sections of the Operations Manual.

23. **The consultations and disclosure carried out to date are appropriate,** given the fact that IIFF has not yet been established and specific subprojects to be financed by IIFF have not

yet been identified. The Borrower will continue to carry out consultations and disclosure activities as the ESSF is updated. Subproject specific safeguards instruments will be subject to consultations and disclosure by IIFF's clients, as required by Bank Policies.

24. **IIFF's clients will disclose EA reports, Land Acquisition and Resettlement Action Plans (LARAPs)**, Indigenous Peoples Plans, etc., in a public place accessible to affected groups, local NGOs and other stakeholders.

I. Institutional Capacity Assessment

25. **Given that IIFF is an entity that will be created as part of the project, specific measures will need to be implemented to build its capacity to review and approve subprojects in accordance to WBG standards.** Under the organizational structure of the IIFF, there will be a fully staffed and operational Environmental and Social Unit in charge of implementing the ESSF. Creation of this Unit, which will be staffed with appropriately qualified environmental and social specialists, will be a condition of loan effectiveness. A team of consultants is currently designing the institutional arrangements for the IIFF, including the following aspects related to the Risk Management/Safeguards Unit: staffing needs, work program, scope of work, responsibility, and reporting requirements. The Unit will ensure that the approved ESSF is implemented effectively and consistently to carry out the environmental and social review of subprojects.

26. **The Operations Manual will specify the roles and responsibilities of the IIFF, SMI and MOF.** The IIFF will develop a program to develop its capacity in the environmental and social areas. It is the responsibility of the WBG to assist and facilitate the implementation of IIFF's capacity building program for the Risk Management/Safeguard Unit. Given that the IIFF is a new institution, the WBG will review the environmental and social aspects of subprojects, and their subsequent implementation by sub-borrowers during at least the first twelve months of project implementation or until institutional capacity satisfactory to the WBG is established to ensure that the ESSF and the Operations Manual are being implemented effectively and that subprojects fully comply with WBG requirements.

Annex 14: Project Preparation and Supervision

	Planned	Actual
PCN Date	June 2005	June 2005
Initial PID to PIC	April 2009	April 2009
Initial ISDS to PIC	April 2009	April 2009
Appraisal	May 2009	May 2009
Negotiations	May 2009	May 2009
Board/RVP approval	June 2009	
Planned date of effectiveness	October 2009	
Planned date of mid-term review	June 2011	
Planned closing date	Dec 2013	

Key institutions responsible for preparation of the project:
Directorate General State Asset, Ministry of Finance, Indonesia

Bank staff and consultants who worked on the project included:

Name	Title	Unit
P.S. Srinivas	Lead Financial Economist, TTL	EASFP
Tunc Tashin Uyanik	Sector Manager	EASFP
Djauhari Sitorus	Financial Sector Specialist	EASFP
The Fei Ming	Private Sector Development Analyst	EASFP
John Jeffrey Delmon	Senior Infrastructure Specialist	FEU
Neni Lestari	Research Analyst	EASFP
Tim Bulman	Macro Economist Consultant	EASPR
Shubham Chaudhuri	Senior Economist	EASPR
Rajat Narula	Senior Financial Management Specialist	EAPCO
Unggul Suprayitno	Senior Financial Management Specialist	EAPCO
Imad Saleh	Senior Procurement Specialist	EAPCO
Yogana Prasta	Operations Adviser	EACIF
Amien Sunaryadi	Senior Operations Officer	EACIF
Indira Dharmapatni	Senior Operations Officer	EASIS
Andrew Daniel Sembel	Environmental Specialist	EASIS
Melinda Good	Senior Councel	LEGES
Khalid A. Mirza	Sector Manager	EASFP
John Factora	Economist	EASPR
Vivianti Rambe	Environmental Specialist	EASIS
Andri Wibisono	Infrastructure Specialist	EASIS
Shienny Lie	Team Assistant	EACIF

Peer Reviewers: Kamran Khan/Jose Luis Guasch

Bank funds expended to date on project preparation:

1. Bank resources: $318,109.37
2. Trust Funds: N/A
3. Total: $318.109.37

Estimated Approval and Supervision costs:

1. Remaining costs to approval: $50,000
2. Estimated annual supervision cost: $100,000

Annex 15: Documents in the Project File

Bappenas – Infrastructure projects book

1. State Ministry of National Development Planning / National Development Planning Agency, 2009. Public – Private Partnerships. Infrastructure Projects in Indonesia.

Bank's Infrastructure Report

2. World Bank, 2004. "Indonesia: Averting an Infrastructure Crisis". A Framework for Policy and Action.

NBFI report

1. World Bank, 2006. "Unlocking Indonesia's Domestic Financial Resources: The Role of Non-Bank Financial Institutions". Poverty Reduction and Economic Management, Financial and Private Sector Development. Indonesia Country Management Unit.

CRISIL feasibility study for IIFF

1. CRISIL Risk and Infrastructure Solutions Limited, October, 2008. Corporate Strategy and Business Plan for Indonesian Infrastructure Finance Facility (IIFF).

MKK legal guidance note/powerpoint

1. Mochtar Karuwin Komar (MKK), 2008. Legal Report Establishment and Business Plan of IIFF.

Draft OM from CRISIL

1. Minutes of working group meetings with dates of meetings
2. Minutes of the IIFF Working Group Meeting, 22nd January 2008
3. Minutes of the IIFF Working Group Meeting, 2nd April 2008
4. Minutes of the IIFF Working Group Meeting, 22nd May 2008
5. Minutes of the IIFF Working Group Meeting, 13th March 2009

Other background documents

1. World Bank, 2006. Lines of Credit in Bank Operations: Guidance Notes , Washington DC: World Bank
2. World Bank, 2006. "World Bank Lending for Lines of Credit: an IEG Evaluation" - PG 37.
3. World Bank, 2006. "Anti-Corruption Guidelines", Washington, DC: World Bank
4. World Bank, 2006. "Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits" (October 2006)
5. World Bank, 2006. "Guidelines: Procurement under IBRD Loans and IDA Credits" (May 2004, Revised October 2006)
6. World Bank, 2006. "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" (May 2004, Revised October 2006)

Government regulation for SMI

1. Government Regulation of the Republic of Indonesia No. 66 Year 2007 regarding State Equity Participation for Establishment of Company in the area of Infrastructure Financing

2. Government Regulation of the Republic of Indonesia No. 75 Year 2008 to amend Government Regulation of the Republic of Indonesia No. 66 Year 2007 regarding State Equity Participation for Establishment of Company in the area of Infrastructure Financing

Presidential regulation for infrastructure finance companies

1. Presidential Regulation of the Republic of Indonesia No. 9 of the Year 2009 regarding Financing Institution

Ministerial decree on infrastructure finance companies

1. Minister of Finance Regulation regarding Infrastructure Financing Companies signed by the Minister of May 26, 2009.

Relevant project reports

2. Country Partnership Strategy (Indonesia: Country Partnership Strategy FY09-12 (Report No. 44845-IND), 2008).

3. Fifth Development Policy Loan (Indonesia: Fifth Development Policy Loan (DPL 5) (Report No. 46332-ID), 2008).

4. Public Expenditure Support Facility (DPL-DDO) (Indonesia: Public Expenditure Support Facility (PESF) Development Policy Loan with Deferred Drawdown Option (DPL-DDO) (Report No. 47280-ID), 2009.

5. Second Infrastructure Development Policy Loan (Indonesia: Second Infrastructure Development Policy Loan (Report No. 46328-ID), 2008.

Annex 16: Statement of Bank Loans and Credits

INDONESIA: Indonesia Infrastructure Finance Facility

			Original Amount in US$ Millions						Difference between expected and actual disbursements	
Project ID	FY	Purpose	IBRD	IDA	SF	GEF	Cancel.	Undisb.	Orig.	Frm. Rev'd
P107661	2009	ID – BOS KITA Project	600.00	0.00	0.00	0.00	0.00	427.72	0.00	0.00
P109196	2009	ID - PNPM UPP additional financing	115.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
P115199	2009	Public Expend. Supp. Facility (DPL-DDO)	2000.00	0.00	0.00	0.00	0.00	2000.00	0.00	0.00
P107163	2008	ID – Infrastructure DPL (IDPL)	200.00	0.00	0.00	0.00	0.00	200.00	0.00	0.00
P097104	2008	ID-BERMUTU	24.50	61.50	0.00	0.00	0.00	85.86	0.00	0.00
P083742	2007	ID-Farmer Empower. Agric.Tech.&Info	32.80	60.00	0.00	0.00	0.00	93.51	0.00	0.00
P079906	2007	ID-STRATEGIC ROADS INFRA	208.00	0.00	0.00	0.00	0.00	208.00	0.00	0.00
P077175	2006	ID-Domestic Gas Market Development Proj.	80.00	0.00	0.00	0.00	0.00	66.33	6.33	0.00
P085375	2006	ID-WSSLIC III (co-TTL=Claudia Rokx)	0.00	137.50	0.00	0.00	0.00	142.62	7.90	0.00
P089479	2006	ID-Early Childhood Education and Dev	0.00	67.50	0.00	0.00	0.00	70.02	0.02	0.00
P071296	2005	ID-US$RP	45.00	0.00	0.00	0.00	0.00	42.76	1.16	0.00
P084583	2005	ID-UPP3	67.30	71.40	0.00	0.00	0.00	78.63	-11.34	0.00
P078070	2005	Support for Poor and Disadvantaged Areas	69.00	35.00	0.00	0.00	0.00	124.26	16.32	0.00
P076174	2005	ID-Initiatives for Local Govern. Reform	14.50	15.00	0.00	0.00	0.00	38.01	11.48	0.00
P085133	2005	Govt Finl Mgt & Revenue Admin Project	55.00	5.00	0.00	0.00	0.00	58.92	23.14	0.00
P085374	2005	ID-HIGHER EDUCATION	50.00	30.00	0.00	0.00	0.00	68.75	11.49	0.00
P092019	2005	Kecamatan Development Project 3B	80.00	80.00	0.00	0.00	0.00	182.54	14.79	0.00
P074290	2004	ID-E. IND REG TRANSPT 2	200.00	0.00	0.00	0.00	1.00	159.19	98.19	0.00
P084860	2004	ID-PCF-Indocement Cement	0.00	0.00	0.00	0.00	0.00	10.73	0.00	0.00
P071316	2004	ID - Coral Reef Rehab and Mgmt Prog II	33.20	23.00	0.00	0.00	0.17	44.46	13.41	0.00
P071318	2004	ID - Coral Reef Rehab and Management II	0.00	0.00	0.00	7.50	0.00	6.81	2.81	0.00
P064728	2004	ID-LAND MANAGEMENT &POLICY DEVT PROJECT	32.80	32.80	0.00	0.00	0.16	44.56	13.48	0.00
P079156	2003	ID Third Kecamatan Development Project	204.30	45.50	0.00	0.00	0.00	2.28	-5.26	0.00
P076271	2003	ID-PPITA	17.10	0.00	0.00	0.00	0.00	4.52	4.52	1.82
P073772	2003	ID-Health Workforce & Services (PHP 3)	31.10	74.50	0.00	0.00	0.00	64.42	43.59	-10.30
P063913	2003	ID-Java-Bali Pwr Sector & Strength	141.00	0.00	0.00	0.00	0.00	112.02	97.92	9.58
P059931	2003	ID-Water Resources & Irr.Sector Mgt Prog	45.00	25.00	0.00	0.00	0.00	64.76	62.80	13.68
P073970	2002	ID-GLOBAL DEV LEARNING (LIL)	2.66	0.00	0.00	0.00	0.00	1.30	1.30	0.00
P072852	2002	ID-UPP2	29.50	70.50	0.00	0.00	0.00	140.09	-14.58	14.00
P073025	2001	ID-SECOND KECAMATAN DEVELOPMENT PROJECT	208.90	111.30	0.00	0.00	0.00	5.79	-8.88	0.00
P059477	2000	ID-WSSLIC II (co-TTL=Claudia Rokx)	0.00	77.40	0.00	0.00	0.00	18.80	11.87	0.00
P049545	2000	ID-PROVINCIAL HEALTH I	0.00	38.00	0.00	0.00	3.17	6.77	7.28	7.28
		Total:	4,586.66	1,060.90	0.00	7.50	4.50	4,574.43	409.74	36.06

Annex 17: STATEMENT OF IFC's

Held and Disbursed Portfolio

In Millions of US Dollars

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
2006	Bank Danamon	155.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2004	BonaVista School	1.00	0.00	0.00	0.00	1.00	0.00	0.00	0.00
2006	Buana Bank	5.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2006	Centralpertiwi	45.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2004	Medan NP School	1.75	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2002	P T Gawi	11.05	0.00	0.00	3.49	4.90	0.00	0.00	3.49
1989	PT Agro Muko	0.00	2.20	0.00	0.00	0.00	2.20	0.00	0.00
1997	PT Alumindo	2.73	0.00	0.00	0.00	2.73	0.00	0.00	0.00
1989	PT Astra	0.00	0.20	0.00	0.00	0.00	0.20	0.00	0.00
1994	PT Astra	0.00	0.19	0.00	0.00	0.00	0.19	0.00	0.00
2003	PT Astra	0.00	0.12	0.00	0.00	0.00	0.12	0.00	0.00
	PT Astra Otopart	0.00	0.70	0.00	0.00	0.00	0.70	0.00	0.00
2005	PT Astra Otopart	24.00	0.00	0.00	0.00	24.00	0.00	0.00	0.00
2000	PT Bank NISP	0.00	2.85	2.86	0.00	0.00	2.85	2.83	0.00
2002	PT Bank NISP	0.00	2.04	0.00	0.00	0.00	2.04	0.00	0.00
2004	PT Bank NISP	35.00	0.00	0.00	0.00	35.00	0.00	0.00	0.00
1997	PT Berlian	0.00	3.35	0.00	0.00	0.00	0.00	0.00	0.00
1993	PT Bina Danatama	0.05	0.00	0.00	0.00	0.05	0.00	0.00	0.00
1996	PT Bina Danatama	0.00	0.00	2.58	4.81	0.00	0.00	2.58	4.81
2004	PT Ecogreen	30.00	0.00	0.00	0.00	30.00	0.00	0.00	0.00
2005	PT Ecogreen	25.00	0.00	0.00	0.00	20.00	0.00	0.00	0.00
	PT Grahawita	0.00	0.00	3.75	0.00	0.00	0.00	3.75	0.00
1991	PT Indo-Rama	0.00	3.82	0.00	0.00	0.00	3.82	0.00	0.00
1995	PT Indo-Rama	0.00	1.57	0.00	0.00	0.00	1.57	0.00	0.00
1999	PT Indo-Rama	0.00	0.81	0.00	0.00	0.00	0.81	0.00	0.00
2001	PT Indo-Rama	20.00	0.00	0.00	0.00	0.33	0.00	0.00	0.00
2004	PT Indo-Rama	48.00	0.00	0.00	0.00	41.00	0.00	0.00	0.00
1992	PT KIA Keramik	0.23	0.00	0.00	2.00	0.23	0.00	0.00	2.00
1996	PT KIA Keramik	1.65	0.00	0.00	53.49	1.65	0.00	0.00	53.49
1995	PT KIA Serpih	4.50	0.00	0.00	49.50	4.50	0.00	0.00	49.50
1997	PT Kalimantan	9.38	0.00	0.00	0.00	9.38	0.00	0.00	0.00
	PT Karunia (KAS)	16.45	0.00	0.00	3.56	16.45	0.00	0.00	3.56
2006	PT Karunia (KAS)	20.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	PT Makro	0.00	2.54	0.00	0.00	0.00	2.54	0.00	0.00
2000	PT Makro	0.00	1.21	0.00	0.00	0.00	0.71	0.00	0.00
2006	PT Makro	0.00	0.66	0.00	0.00	0.00	0.66	0.00	0.00
1998	PT Megaplast	0.00	2.50	0.00	0.00	0.00	2.50	0.00	0.00
1993	PT Nusantara	0.00	0.00	10.16	7.90	0.00	0.00	10.16	7.90
2004	PT Prakars (PAS)	15.36	0.00	0.00	3.20	15.36	0.00	0.00	3.20
1997	PT Sayap	0.83	0.00	0.00	0.00	0.83	0.00	0.00	0.00

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
2001	PT Sigma	0.00	1.03	0.00	0.00	0.00	1.03	0.00	0.00
2006	PT TAS	7.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1995	PT Viscose	7.81	0.00	0.00	0.00	7.81	0.00	0.00	0.00
2004	PT Viscose	8.31	0.00	0.00	0.00	8.31	0.00	0.00	0.00
1997	PT Wings	0.72	0.00	0.00	0.00	0.72	0.00	0.00	0.00
2001	Sunson	11.62	0.00	0.00	7.35	11.62	0.00	0.00	7.35
2005	WOM	0.00	15.82	0.00	0.00	0.00	15.74	0.00	0.00
2006	WOM	20.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2004	Wilmar	33.33	0.00	0.00	0.00	33.33	0.00	0.00	0.00
	Total portfolio:	560.77	41.41	19.35	135.30	269.20	37.48	19.32	135.30

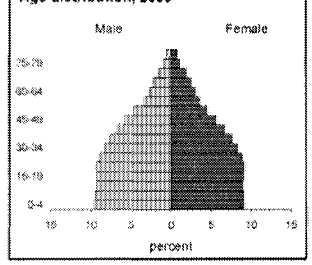
		Approvals Pending Commitment			
FY Approval	Company	Loan	Equity	Quasi	Partic.
2005	Bank NISP SELF	0.03	0.00	0.00	0.00
2006	Bank NISP Swap	0.00	0.00	0.00	0.00
2006	Orix Indonesia	0.08	0.00	0.00	0.00
	Total pending commitment:	0.11	0.00	0.00	0.00

Annex 18: INDONESIA AT A GLANCE

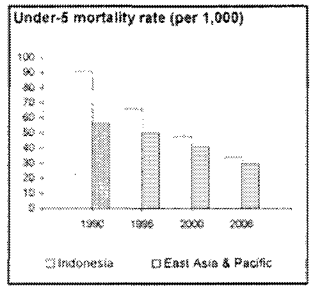
Indonesia at a glance

1/26/09

Key Development Indicators	Indonesia	East Asia & Pacific	Lower middle income
(2007)			
Population, mid-year (millions)	225.6	1,914	3,437
Surface area (thousand sq. km)	1.905	16,299	35,510
Population growth (%)	1.2	0.8	1.0
Urban population (% of total population)	50	43	42
GNI (Atlas method, US$ billions)	373.1	4,174	6,485
GNI per capita (Atlas method, US$)	1.650	2,180	1,887
GNI per capita (PPP international $)	3.580	4,941	4,544
GDP growth (%)	6.3	10.5	9.7
GDP per capita growth (%)	5.1	9.6	8.6
(most recent estimate, 2000–2007)			
Poverty headcount ratio at $1.25 a day (PPP, %)	..	18	..
Poverty headcount ratio at $2.00 a day (PPP, %)	..	40	..
Life expectancy at birth (years)	68	71	69
Infant mortality (per 1,000 live births)	26	24	41
Child malnutrition (% of children under 5)	24	13	25
Adult literacy, male (% of ages 15 and older)	94	95	93
Adult literacy, female (% of ages 15 and older)	87	87	85
Gross primary enrollment, male (% of age group)	116	111	112
Gross primary enrollment, female (% of age group)	112	109	109
Access to an improved water source (% of population)	80	87	88
Access to improved sanitation facilities (% of population)	52	66	54

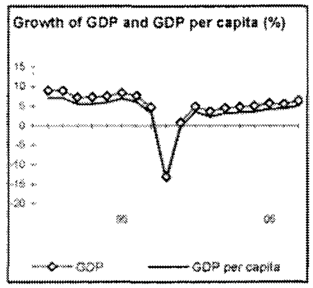


Age distribution, 2006



Under-5 mortality rate (per 1,000)

Net Aid Flows	1980	1990	2000	2007	2008
(US$ millions)					
Net ODA and official aid	941	1,716	1,654	1,405	
Top 3 donors					
Australia	48	77	72	310	
United States	117	31	174	190	
European Commission	1	12	38	137	
Aid (% of GNI)	1.3	1.6	1.1	0.4	
Aid per capita (US$)	6	10	8	6	



Growth of GDP and GDP per capita (%)

Long-Term Economic Trends	1980	1990	2000	2007	2008
Consumer prices (annual % change)	9.5	7.5	3.7	6.5	11.1
GDP implicit deflator (annual % change)	31.0	7.7	20.4	11.5	
Exchange rate (annual average, local per US$)	627	1,843	8,422	9,143	9,656
Terms of trade index (2000 = 100)		301	100	95	

	1980	1990	2000	2007	1980–90	1990–2000	2000–07
					(average annual growth %)		
Population, mid-year (millions)	148.3	178.2	206.3	225.6	1.8	1.5	*1.3*
GDP (US$ millions)	78,013	114,426	165,021	432,817	6.1	4.2	*5.1*
		(% of GDP)					
Agriculture	24.0	19.4	15.6	13.8	3.6	2.0	*3.2*
Industry	41.7	39.1	45.9	46.7	7.3	5.2	*4.1*
Manufacturing	13.0	20.7	27.7	27.0	12.8	6.7	*5.1*
Services	34.3	41.5	38.5	39.4	6.5	4.0	*6.8*
Household final consumption expenditure	51.4	58.9	60.7	62.8	5.2	6.6	*4.8*
General gov't final consumption expenditure	10.6	8.8	6.5	8.3	4.6	0.1	*7.9*
Gross capital formation	24.1	30.7	22.2	24.9	7.7	-0.6	*5.7*
Exports of goods and services	34.2	25.3	41.0	29.4	2.7	5.9	*8.3*
Imports of goods and services	20.2	23.7	30.5	25.3	1.2	5.7	*9.8*
Gross savings	*28.7*	28.1	28.3	26.1			

Note. Figures in italics are for years other than those specified. 2007 data are preliminary. .. indicates data are not available.
a. Aid data are for 2006.

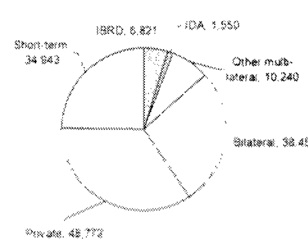
Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade	2000	2007	2008
(US$ millions)			
Total merchandise exports (fob)	62,124	114,101	
Total merchandise imports (cif)	36,196	91,724	
Net trade in goods and services	29,862	21,981	
Current account balance	23,982	11,010	
as a % of GDP	14.5	2.5	
Workers' remittances and compensation of employees (receipts)	1,190	6,143	
Reserves, including gold	29,268	55,626	51,639

Central Government Finance	2000	2007	2008
(% of GDP)			
Current revenue (including grants)	19.7	17.9	19.9
Tax revenue	11.1	12.4	13.3
Current expenditure	15.6	11.1	19.9
Overall surplus/deficit	-1.8	-1.3	-0.1
Highest marginal tax rate (%)			
Individual	35	35	35
Corporate	30	30	30

External Debt and Resource Flows	2000	2007
(US$ millions)		
Total debt outstanding and disbursed	144,286	140,783
Total debt service	16,622	14,647
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	87.4	32.5
Total debt service (% of exports)	11.2	10.6
Foreign direct investment (net inflows)	-4,550	*5,580*
Portfolio equity (net inflows)	-1,021	*1,898*

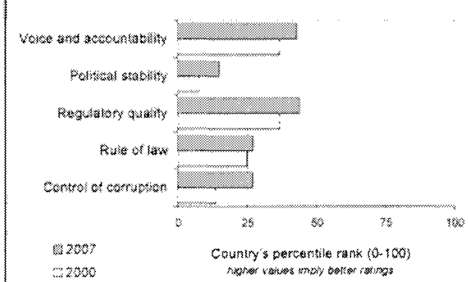
Composition of total external debt, 2007



US$ millions

Private Sector Development	2000	2007	2008
Time required to start a business (days)	–	–	76
Cost to start a business (% of GNI per capita)	–	–	77.9
Time required to register property (days)	–	–	39
Ranked as a major constraint to business	**2000**	**2007**	**2008**
(% of managers surveyed who agreed)			
Economic and regulatory policy uncertainty	..	*48.2*	
Corruption	..	*41.5*	
Stock market capitalization (% of GDP)	16.3	48.9	22.7
Bank capital to asset ratio (%)	6.0	11.1	

Governance indicators, 2000 and 2007



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	2000	2007
Paved roads (% of total)	57.1	*55.3*
Fixed line and mobile phone subscribers (per 100 people)	5	44
High technology exports (% of manufactured exports)	16.2	*13.2*

Environment	2000	2007
Agricultural land (% of land area)	25	*26*
Forest area (% of land area)	54.0	*48.8*
Nationally protected areas (% of land area)	..	*14.3*
Freshwater resources per capita (cu. meters)	..	*12,867*
Freshwater withdrawal (% of internal resources	*2.9*	..
CO2 emissions per capita (mt)	1.8	*1.7*
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	3.7	*3.9*
Energy use per capita (kg of oil equivalent)	740	*814*

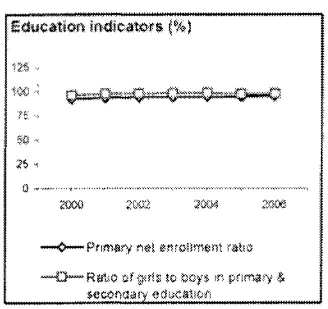
World Bank Group portfolio	2000	2007
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	11,715	6,821
Disbursements	1,051	767
Principal repayments	761	1,369
Interest payments	950	435
IDA		
Total debt outstanding and disbursed	714	1,550
Disbursements	59	219
Total debt service	31	38
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	880	657
of which IFC own account	480	527
Disbursements for IFC own account	20	225
Portfolio sales, prepayments and repayments for IFC own account	43	38
MIGA		
Gross exposure	56	50
New guarantees	0	0

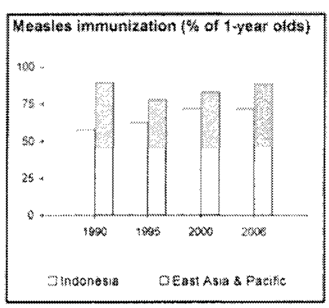
Note: Figures in italics are for years other than those specified. 2007 data are preliminary. 1/26/09
.. indicates data are not available. – indicates observation is not applicable.

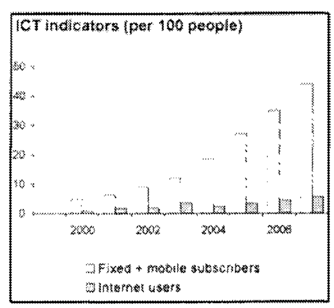
Development Economics, Development Data Group (DECDG).

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Indonesia			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2007**
Poverty headcount ratio at $1.25 a day (PPP % of population)	..	..	..	..
Poverty headcount ratio at national poverty line (% of population)	..	*17.5*	*27.1*	*16.7*
Share of income or consumption to the poorest quintile (%)	..	*7.8*	9.2	*7.1*
Prevalence of malnutrition (% of children under 5)	*31.0*	27.4	24.8	*24.4*
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	*96*	..	93	*96*
Primary completion rate (% of relevant age group)	94	96	*95*	*99*
Secondary school enrollment (gross, %)	*45*	..	55	*64*
Youth literacy rate (% of people ages 15-24)	96	..	..	*99*
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	*93*	..	96	*98*
Women employed in the nonagricultural sector (% of nonagricultural employment)	29	29	32	..
Proportion of seats held by women in national parliament (%)	12	*13*	*8*	11
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	91	66	48	*34*
Infant mortality rate (per 1,000 live births)	60	48	36	*26*
Measles immunization (proportion of one-year olds immunized, %)	58	63	72	72
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	*420*
Births attended by skilled health staff (% of total)	*32*	*37*	*64*	*72*
Contraceptive prevalence (% of women ages 15-49)	*50*	55	..	*57*
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	*0.1*	0.2
Incidence of tuberculosis (per 100,000 people)	343	304	270	*234*
Tuberculosis cases detected under DOTS (%)	..	1	20	*73*
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	72	74	77	*80*
Access to improved sanitation facilities (% of population)	51	51	52	*52*
Forest area (% of total land area)	64.3	..	54.0	*48.8*
Nationally protected areas (% of total land area)	..	..	..	*14.3*
CO2 emissions (metric tons per capita)	1.2	1.6	1.8	*1.7*
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	3.6	4.1	3.7	*3.9*
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	0.6	1.7	3.2	7.9
Mobile phone subscribers (per 100 people)	0.0	0.1	1.8	36.3
Internet users (per 100 people)	0.0	0.0	0.9	5.8
Personal computers (per 100 people)	0.1	0.5	1.0	*2.0*







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Development Economics, Development Data Group (DECDG).

MAP SECTION


INDONESIA
SELECTED CITIES AND TOWNS
PROVINCE CAPITALS
NATIONAL CAPITAL
RIVERS
MAIN ROADS
RAILROADS
PROVINCE BOUNDARIES
INTERNATIONAL BOUNDARIES
This map was produced by the Map Design Unit of The World Bank. The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of The World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.
PROVINCES:
1 NANGGROE ACEH DARUSSALAM
2 SUMATERA UTARA
3 RIAU
4 SUMATERA BARAT
5 JAMBI
6 BENGKULU
7 SUMATERA SELATAN
8 LAMPUNG
9 BANGKA-BELITUNG
10 BANTEN
11 D.K.I. JAKARTA
12 JAWA BARAT
13 JAWA TENGAH
14 D.I. YOGYAKARTA
15 JAWA TIMUR
16 BALI
17 NUSA TENGGARA BARAT
18 NUSA TENGGARA TIMUR
19 RIAU KEPULAUAN
20 KALIMANTAN BARAT
21 KALIMANTAN TENGAH
22 KALIMANTAN SELATAN
23 KALIMANTAN TIMUR
24 SULAWESI UTARA
25 GORONTALO
26 SULAWESI TENGAH
27 SULAWESI BARAT
28 SULAWESI SELATAN
29 SULAWESI TENGGARA
30 MALUKU UTARA
31 MALUKU
32 PAPUA BARAT
33 PAPUA
0 200 400 Kilometers
0 100 200 300 400 Miles
INDONESIA
VIETNAM
PHILIPPINES
MALAYSIA
BRUNEI
SINGAPORE
TIMOR-LESTE
PAPUA NEW GUINEA
AUSTRALIA
PACIFIC OCEAN
INDIAN OCEAN
Sulu Sea
Celebes Sea
Java Sea
Banda Sea
Arafura Sea
SUMATERA
KALIMANTAN
SULAWESI
JAWA
PAPUA
JAKARTA
Banda Aceh
Medan
Pematangsiantar
Pekanbaru
Padang
Jambi
Bengkulu
Palembang
Pangkalpinang
Tanjungpinang
Bandar Lampung
Serang
Bandung
Semarang
Yogyakarta
Surabaya
Denpasar
Mataram
Raba
Ende
Waingapu
Kupang
Pontianak
Palangkaraya
Bandjarmasin
Samarinda
Balikpapan
Tarakan
Mamuju
Palu
Gorontalo
Manado
Parepare
Makassar
Kendari
Baubau
Ternate
Ambon
Amahai
Sorong
Manokwari
Fakfak
Timika
Jayapura
Merauke
Puncak Jaya (5030 m)
Simeulue
Nias
Siberut
Mentawai Is.
Enggano
Lingga
Natuna Besar
Bangka
Belitung
Madura
Bali
Lombok
Sumbawa
Flores
Sumba
Timor
Alor
Wetar
Moa
Babar
Tanimbar Is.
Kai Is.
Aru Is.
Buru
Ceram
Obi
Misool
Waigeo
Halmahera
Morotai
Talaud Is.
Peleng
Sula Is.
Muna
Yapen
Biak
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