By Diaan-Yi Lin

Can public private partnerships solve Indonesia's infrastructure needs?

Public private partnerships, when delivered successfully, could help Indonesia address critical infrastructure gaps that require investments of $600 billion in the next 10 years.

The urgent need to address Indonesia's critical infrastructure gaps was a key issue during the Presidential campaign, when both candidates pledged to improve the country's infrastructure as a means to drive economic growth. Sustained over time, infrastructure investments will have a huge impact on Indonesia's GDP and longer-term growth prospects.

To achieve its ambitious growth targets, Indonesia needs to address critical infrastructure gaps and invest at least $600 billion in the next 10 years in building and upgrading infrastructure according to estimates by McKinsey & Company. Infrastructure investments have decreased dramatically in the last decade, hovering at 3 – 4 percent of GDP—about half of what is required. A recent World Bank report estimates that Indonesia has lost at least 1 percent of economic growth each year over the past decade as a result. The government's ability to tackle infrastructure investment has been limited by a host of issues including fiscal constraints with significant budget commitments to fuel subsidies. A difficult land acquisition process has been another serious stumbling block. As a result, less than half of the infrastructure projects planned for this year—13 out of 34—will be launched.

A $180 billion opportunity for PPPs

Public-private partnerships (PPPs) can help bridge some of the investment gap by bringing in private finance. The PPP model transfers to the private sector responsibility for financing, designing and constructing an asset, as well as some of the responsibilities for operating and maintaining it after completion. In several emerging countries such as India, Mexico and Brazil, PPPs are contributing 25 – 30 percent to infrastructure development, on average, at a lower cost and faster delivery time than traditional procurement. PPPs in Indonesia offer an estimated $180 billion opportunity if they could meet 30 percent of Indonesia's infrastructure needs, based on these international benchmarks.

The Indonesian government has shown strong commitment to involving the private sector in infrastructure development. In 2005, Indonesia introduced the legal concept of PPPs to boost procurement through a competitive tender process. Other regulations were also introduced to encourage private investments in sectors including telecommunications, oil and gas, railways, ports, electricity, and water and sanitation. More recently, the Land Acquisition Law was amended to ease the land clearing process. In addition, fiscal support has been made available throughout the PPP process. The government's Project Development Facility, for example, is a revolving fund for feasibility studies during project preparation.

Despite the efforts, however, few PPPs in Indonesia have been able to finalize contract terms. According to BAPPENAS, Indonesia's Ministry of National Development Planning, only 24 PPPs have made it to construction or operation, with no new PPPs reaching financial close—signed contracts between the government, winning bidder and financing parties—since 2009. Most are stuck in the preparation and transaction stages. Out of the 48 PPP projects worth more than $57 billion (approximately 570 trillion rupiah) announced in 2013 by BAPPENAS, 26 are in preparation stage and 21 are in transaction stage. Even the five PPPs identified as showcase projects are struggling, and only one—the Central Java Power Plant—is signed and currently embarking on financial close.

Indonesia's PPP gridlock

To understand why PPPs remain in gridlock in Indonesia, McKinsey made an assessment of the process of PPP management in Indonesia, and found several critical challenges that explain why few PPPs succeed.

First is the lack of transparency on how projects are selected and prioritized as PPPs. The number of PPP projects initially listed by BAPPENAS has changed drastically; going down from 100 listed projects worth $46.8 billion in 2010 to 27 projects worth USD 45.7 billion in 2013. The status of several projects has also been downgraded, with no clear rationale for change. The Pondok Gede Water Supply project, for example, was classified as "ready for offer" in 2011, and downgraded to "priority" in 2012 without any explanation. The lack of transparency and consistency makes it hard for the private sector to make commitments and undermines the credibility of Indonesia's PPP process.

Second, PPPs are still viewed primarily as a means of financing, and often perceived as too complex because of the extensive coordination required for implementation. PPPs involve more stakeholders (e.g., financiers, construction firms, government ministries) and more steps to complete than traditional public procurement. Contracting agencies, for example, have the additional responsibility of allocating risk between public and private stakeholders and drafting more complicated bid proposals for the multiple stakeholders. As a result, they often prefer to use public budget funds or international grants, which are much easier to administer. PPPs become the last resort, typically used for lower priority projects.

Third, many government contracting agencies lack the right set of skills. PPPs are a complex undertaking, requiring specialized skills in structuring transactions, financial analysis and modeling, commercial legal expertise and more. Contracting agencies often lack the project finance skills to develop pre-feasibility studies, to allocate risks, to structure the PPP, and to interact and negotiate with private investors. Projects that have not been formulated well have resulted in PPP concessions being cancelled and projects being returned to the government. The Medan-Kuala Namu and Cileunyi-Sumedang-Dawuan PPPs, for example, were converted into government funded projects in 2009 due to lack of investor interest.

With more than 45 laws and regulations governing PPPs in Indonesia, many provisions in the PPP regulatory framework conflict or overlap across different levels of government, and across different agencies. This creates confusion among the investor community and contracting agencies, further deterring them from participating in PPPs. Furthermore, Indonesia's cumbersome PPP permit process entails obtaining more than 40 permits and licenses from an array of government agencies, with a PPP entity required to apply for a business license, secure approvals for the project's technical specifications, obtain operating permits, and secure approval for construction. The Central Java Power Plant required more than 50 permits and licenses prior to construction. While this is not uncommon in developing countries, Indonesia's decentralized government adds further complexity, with regional permitting agencies issuing conflicting approvals. For example, regents at the sub-provincial level can stall the approval of environmental impact permits even when requirements have been fulfilled, while line agencies at the national level do not have the authority to challenge such decisions.

Finally, land acquisition, a major challenge in any infrastructure project, has crippled several infrastructure projects with the private sector required to cover up to 30 – 40 percent of the total investment costs. New enabling laws have been put into place, for example, the new Land Acquisition bill in 2012 which speeds up the process with time limits established to contest and sell land, independent appraisals for property valuation and responsibilities designation for every stage of the process. However, the law does not apply retroactively, meaning only new projects that have not yet started their land acquisition processes, will benefit.

Capturing the $180 billion PPP opportunity in Indonesia requires new approaches. For the partnerships to have impact, the new Indonesian government needs to focus on driving change across contracting agencies at the national and regional level, bringing PPPs into the mainstream and unequivocally supporting private sector involvement in infrastructure development. A strong and centralized body should be established to support PPPs. Addressing process inefficiencies is necessary, and, at the same time building the skills and competencies of contracting agencies at scale. The new government should also proactively support and deliver on 2 – 3 priority projects within the next 6 – 12 months, to demonstrate its renewed commitment to PPPs. These projects can be selected from the current five showcase projects that are currently stalled. The success of these projects would go a long way to enable significant change, creating confidence in Indonesia's infrastructure opportunity for the future.

Diaan-Yi Lin is a Partner in McKinsey's Southeast Asia office