

Strengthening Private Sector Participation for
Infrastructure in the Pacific Region
17-22 November 2008, Brisbane, Australia

Risk Allocation Exercise: A Municipal Water Supply Concession in Indonesia

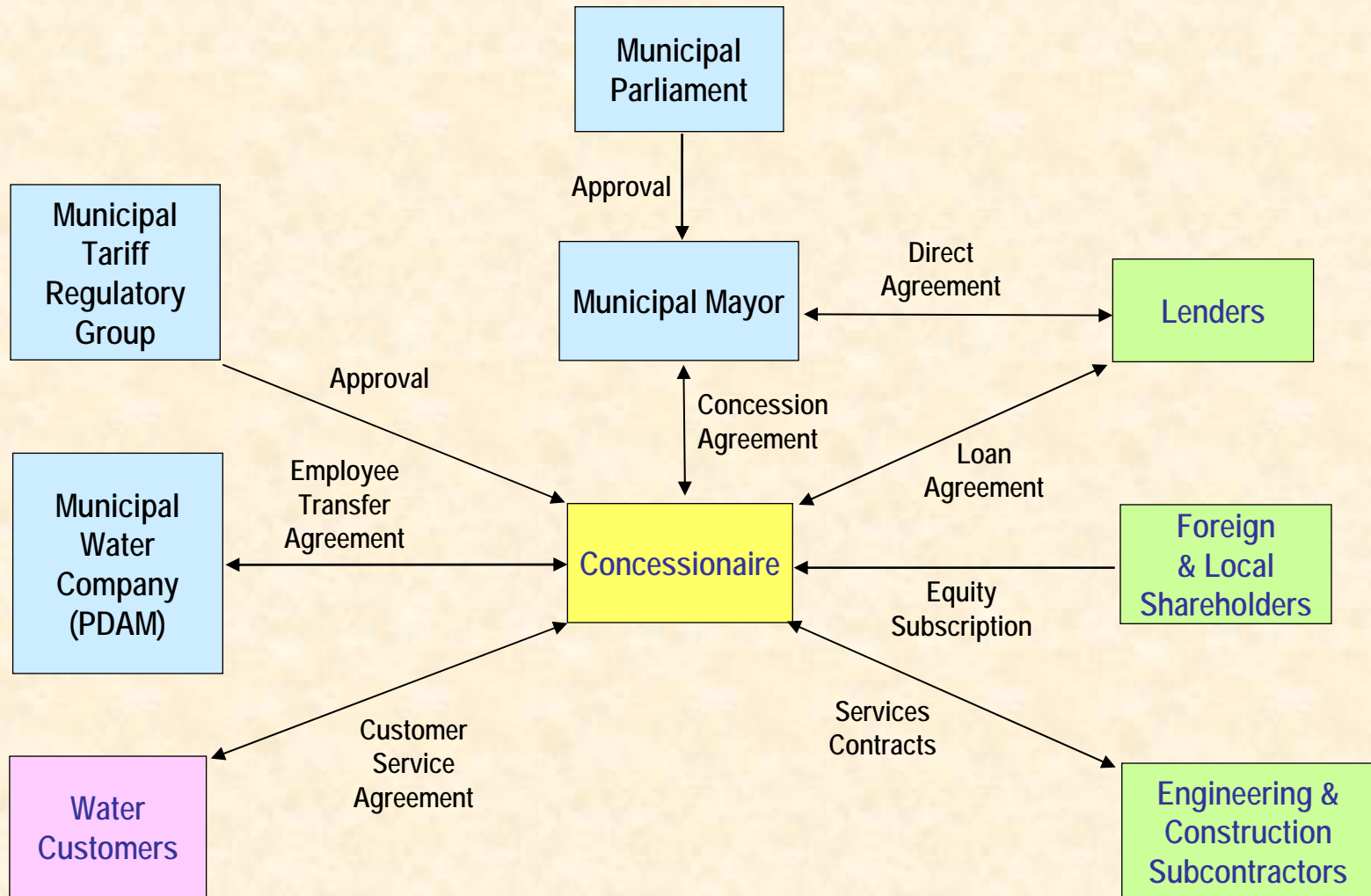
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Concession Description

Location	A municipality on the island of Sumatra; capital of the province; population of 600,000; major producer of oil, palm oil, timber, and agri-products
Concession	Exclusive right (and obligation) to finance, rehabilitate, expand, operate and maintain the water treatment facilities and distribution network of the Municipal Water Company (PDAM) for a period of 30 years
Award of Concession	Competitive bidding: 4 pre-qualified bidders, 2 bids submitted. Concession Agreement signed in Jan 2001 subject to certain conditions precedent
Concessionaire	Consortium of a foreign water operator (with an existing concession in another Indonesian city) and 2 local contractors

Proposed Contractual & Financing Structure



Performance Targets and Benchmarks

Service Coverage	Increase from 12 percent to 70 percent of the population by year 10
Water Losses	Reduce from 56 percent to 20 percent by year 30
Water Quality	Comply with WHO standards for drinking water by year 10
Service Quality	Defined minimum periods for restoration of services, frequency of outages, and average duration of outages

- The Concessionaire would be subject to financial penalties for failure to meet the performance obligations.
- Such failure could also result in lower revenues and/or higher capital expenditure than planned.

Regulatory Structure

- Regulatory function would be performed by a Tariff Regulatory Group
- Three members appointed by the Mayor
- Responsible for
 - monitoring compliance of Concessionaire with performance benchmarks
 - approving tariff adjustments under terms of concession agreement
- Cannot require Concessionaire to exceed agreed obligations
- Its decisions would not be subject to approval or concurrence of any other government body or agency (?)

The Municipal Parliament (DPRD) had the right to approve any changes to water tariffs and had to relinquish this right.

Tariff Adjustment

Ordinary Tariff Adjustment (OTA)	For annual inflation based on published consumer price index
Extraordinary Tariff Adjustment (ETA)	For certain extraordinary events, such as currency devaluation, changes in law, etc., that are beyond the control of the Concessionaire

- The final method of computing the ETA was to be agreed between the Concessionaire and the Municipality. This was a condition precedent in the Concession Agreement.
- The prospective Lenders were seeking a Direct Agreement with the Mayor, approved by the Municipal Parliament (DPRD), on being indemnified if justified tariff adjustment under the Concession Agreement was not implemented.

Allocation of Tariff Revenue

- Tariff revenue would be held in a special account administered by the Concessionaire, and paid in accordance with the following priorities (highest to lowest):
 1. Concession expenses, including all operating, management, finance and tax costs;
 2. The management fee payable to the shareholders of the SPC;
 3. The committee fee;
 4. Monitoring fee paid to the PDAM;
 5. Payment made to the regulator;
 6. Royalty paid to the Municipality;
 7. Super profit royalty paid to the Municipality; and
 8. Dividends paid to the concessionaire.

Dispute Resolution

- **First stage: conciliatory negotiation** within a committee to be established consisting of two representatives from each party for up to one month
- **Second stage: mediation** by the regulator who would try to resolve the issue within another month
- **Third stage: arbitration** by the Singapore International Arbitration Center

Allocation of Risks (1)

Risk	C	G	U	Explanation / Risk Mitigation
Inability to adjust user tariff based on agreed tariff formula				
Market demand				
Forecast demand not achieved (non-market)				
Raw water quantity, quality and cost risks				
Forecast level of investment too high relative to actual demand				
Inability to achieve performance targets				

C = Concessionaire; G = Municipal Government; U = Users (Customers); ETA = Extraordinary Tariff Adjustment

Allocation of Risks (2)

Risk	C	G	U	Explanation / Risk Mitigation
Exchange fluctuations & inflation within 1 year				
Exchange fluctuations & inflation				
Public liability				
Natural & political force majeure (insurable)				
Natural & political force majeure (non-insurable)				
Changes in laws, regulations, and environmental rules				
Performance of existing PDAM projects				

C = Concessionaire; G = Municipal Government; U = Users (Customers); ETA = Extraordinary Tariff Adjustment

Conditions Precedent to the Start of Concession

- Start of the concession is subject to fulfillment of certain conditions precedent within a set timeframe
- Agreement on the tariff adjustment formulas and their ratification by the Municipal Parliament
- Establishment of the regulator
- Execution of employment transfer agreement with the PDAM
- Financial closure
- Completion of existing projects of the PDAM

Proposed Debt Financing

Amount	USD 7 million (about 50% of initial capital requirement)
Tenor	10 years inclusive of 4 years grace period
Security	Contingent equity funding support from sponsors up to a certain amount to be released when "financial completion" achieved
	Charge over all cash flows
	Right to appoint a replacement operator in event of early termination of concession (step-in right)
	Assignment of Concessionaire's rights, including the right to receive termination payment
Conditions before loan signing	Direct agreement between Lenders and the Municipality, providing a performance undertaking approved by the Municipal Parliament
	Compliance with conditions for the start of the concession relating to the tariff mechanism, regulatory framework, and undertakings from the Mayor and Municipal Parliament

Allocation of Risks (1) - *ANSWERS*

INDONESIA: MUNICIPAL WATER SUPPLY CONCESSION				
Allocation of Risks (1)				
Risk	C	G	U	Explanation / Risk Mitigation
Inability to adjust user tariff based on agreed tariff formula		X		Withholding payment of royalty fee to municipal govt.; monitoring fee to PDAM, regulatory fee to regulator as per agreed priority of payments from tariff revenue
Market demand	X			Impact of market forces
Forecast demand not achieved (non-market)		X	X	due to right of way problems, ETA
Raw water quantity, quality and cost risks		X	X	Municipal govt. will first use all legal remedies; if it fails, then ETA
Forecast level of investment too high relative to actual demand	X			Concessionaire can mitigate risk by revising the annual investment plan and taking marketing campaigns
Inability to achieve performance targets	X			To the extent there is no event of force majeure or an intervening event

C = Concessionaire; G = Municipal Government; U = Users (Customers); ETA = Extraordinary Tariff Adjustment

Allocation of Risks (2) - ANSWERS

INDONESIA: MUNICIPAL WATER SUPPLY CONCESSION

Allocation of Risks (2)

Risk	C	G	U	Explanation / Risk Mitigation
Exchange fluctuations & inflation within 1 year	X			
Exchange fluctuations & inflation		X	X	Beyond one year, ETA
Public liability	X			Mitigation by insurance
Natural & political force majeure (insurable)	X			
Natural & political force majeure (non-insurable)		X	X	ETA, termination payment
Changes in laws, regulations, and environmental rules	X	X	X	If changes are specific to water industry, or foreign investment, then ETA
Performance of existing PDAM projects		X		

C = Concessionaire; G = Municipal Government; U = Users (Customers); ETA = Extraordinary Tariff Adjustment

Thank You

