THE WORLD BANK

FLOW OF FUNDS, FLOW OF WATER

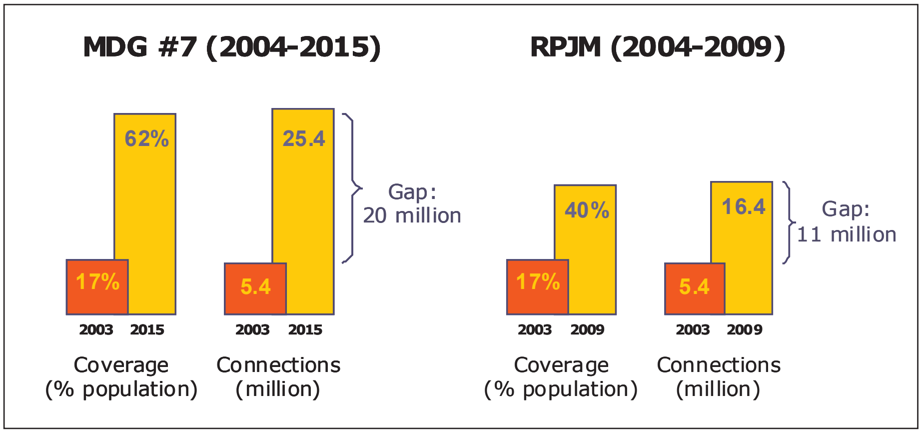
Strategic Priorities for FINANCING PIPED WATER SERVICES in Indonesia

1.SECTOR OVERVIEW

Current state of piped water supply services where is the nation now? Today, fewer than 20% of households in Indonesia have access to piped water, which is inexpensive and still of reasonable quality compared to alternative sources. The situation has deteriorated in recent years, as the sector can no longer rely on central government grants and loans, formerly major sources of funding. Revenues are usually far lower than the full cost of the service due to downward political pressure on tariffs. As a result, PDAMs, which are responsible for the delivery of piped water to most households and other small-scale water users, have resorted to 'stop-gap' measures including deferring essential maintenance expenditures and defaulting on loans from the Ministry of Finance (MoF). Water losses, both physical and administrative, average 50% of production. In some areas, groundwater abstraction through individual and often unregistered wells has reached unsustainably high levels, causing seawater infiltration and land subsidence. Water quality and regularity of service delivery are declining, especially in urban areas, and few (if any) utilities currently supplies potable water. The organization of the sector remains highly fragmented, with over 300 PDAMs providing piped water, of which only 52 operate more than 25,000 connections. Since the 1997/98 monetary crisis, both public and private investment in new piped water infrastructure has come to a standstill. Continuing rapid urbanization (increasing at 3.5% p.a.) indicates that domestic service coverage ratios will only marginally increase over the next 10 years without significant and immediate increases in investment in the sector.

Desired state of piped water supply services where does the nation want to be? The latest national medium-term development plan (RPJM) aims to provide 40% of households with access to piped water by the end of 2009. The National Action Plan on Clean Water (NAP-CW), issued by the Ministry of Public Works (MPW) in 2004, describes a strategy to halve the proportion of people without sustainable access to safe drinking water by 2015, in accordance with Millennium Development Goal #7. The primary means to achieve this is to improve access from its current level of about 17% to 62% in 2015, and reduce dependency on other water sources. This requires a major increase in production and distribution capacity (through a combination of system optimization and system expansion) and the number of household connections (Figure 1). On top of these daunting access targets the Government (through PP16/2005) requires that all water utilities supply potable (as opposed to clean) water by the end of 2008.

Figure 1. Actual vs. planned service coverage targets



2. THE GOVERNMENT'S STRATEGY FOR IMPROVING PIPED WATER SERVICES AND ACHIEVEMENTS TO DATE

Targets for piped water supply until 2015.

- Quantitative targets. The number of households supplied by piped water supply services should increase from 18% in 2004 to 40% by the end of 2009, and to 62% by 2015. The total cost of achieving these targets is estimated at IDR 4.2 trillion (US$ 450 million) per year between 2006 and 2015, or 10 times the amount currently being invested, and even this is considered an underestimate.

- Qualitative targets. By the end of 2008, all public and private water utilities should supply their customers with potable water. (The cost of improving water quality is not included in the above cost estimates.)

The Government's proposed strategy to achieve these targets.

- Improve the performance of existing service providers. GOI foresees that PDAMs will continue to be the most important mechanism for delivering piped water.

- Encourage the development of new service providers. GOI intends to promote public-private partnerships (PPPs), communities, public service agencies (BLUs) and cooperative ventures between PDAMs as alternative providers of piped water.

- Improve access of service providers to sources of funding. As shown in Figure 2, over 60% of the estimated cost of the optimization and expansion of piped water supply systems will be financed from multilateral and bilateral loans, followed by local governments' own resources (18%), commercial loans (11%) and central government grants (9%).

The Government's achievements since 2004. Between 2000 and 2004, the number of household connections increased by 1.6 million, or 300,000 per year. To reach Millennium Development Goal (MDG) #7, at least 2 million connections must be added every year (a sevenfold increase on recent annual achievements). Reliable data on the performance of the piped water sector are not available since 2004, the year in which the RPJM and the NAP-CW were issued. It is, however, unlikely that the number of connections has increased significantly since then, as:

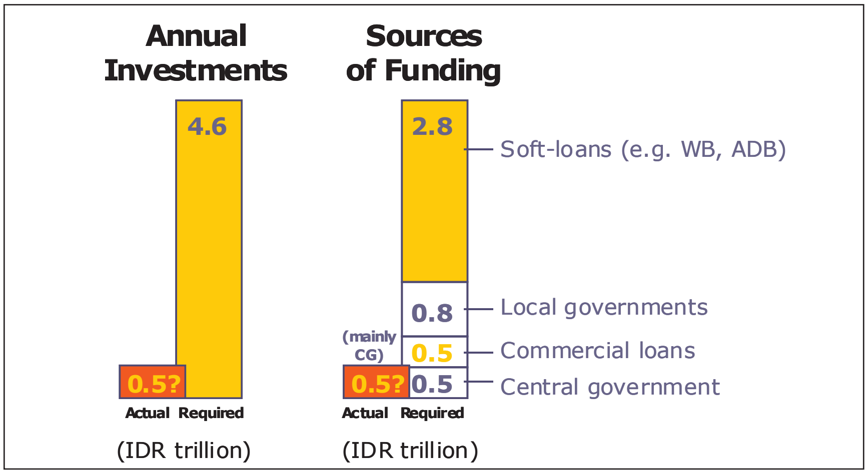
- Multilateral and bilateral financial institutions (which are expected to finance 61% of the piped water sector according to the NAP-CW) have extended no new loans to PDAMs through GOI since 2000.

- There is no evidence that piped water tariffs have increased in real terms since 1997/98. In general, tariffs do not raise sufficient revenues for PDAMs to become financially independent, i.e. no additional surpluses are being generated by PDAMs to support borrowing from multilateral or bilateral financiers nor from commercial financiers (which are expected to provide 11% of sector financing).

- Central government spending, historically the most important source of funding for piped water supply, has not increased significantly in recent years.

- Only three PPP agreements have been concluded since 2000 (with a total value of USD 10.5 million, or about 2% of total annual investment requirements).

Figure 2. Funding sources for piped water supply systems, 2004-2015 (IDR trn)



3. POTENTIAL IMPACTS OF THE LACK OF PROGRESS

What will happen if current trends persist? Based on recent history, there are strong indications that the piped water sector is in a downward trajectory. Without urgent and appropriate action, it is quite unrealistic to expect that GOI will achieve its objectives stated in the RPJM, NAP-CW and PP16/2005. Extrapolation of current trends indicate:

- Marginal improvements in domestic service coverage ratios as waiting lists continue to be unsatisfied and in-migration to urban areas continues to grow. Coverage in 2015 might be 25% compared to the Government's target of 62%, and the current level of 17%.
- The minority that have service connections will face deteriorating operating conditions, with higher levels of water losses, leading to worsening service delivery, which is already unsatisfactory at most PDAMs.
- Increases in the incidence of water-borne diseases, as more and more people rely on unsafe and increasingly polluted alternative sources of water.
- Higher costs for the community of obtaining water from alternative sources.
- Financial collapse at less healthy PDAMs without local government subsidies.

Who pays the price for lack of progress? The costs of inadequate service provision will ultimately be borne by all Indonesian citizens due to: (i) unrealized health and economic benefits; (ii) substantially higher costs of obtaining water from other providers; and (iii) accelerated degradation of assets resulting in an exponential increase in operating costs over time, leading to higher-than-necessary costs of water provided by inefficient utilities. Most of these costs will be disproportionately borne by the urban poor, who currently have no access to piped water.

4. TIME FOR ACTION

The need for well-planned and sizeable interventions. Meeting the Millennium Development Goal #7 will require a strategic approach driven by sound commercial and professional principles to improve the quality, coverage and efficiency of service delivery. The World Bank strongly supports the Government's efforts to provide better piped water services, but fully recognizes that the challenge is enormous and calls for well planned and sizeable interventions, with discussions to begin as soon as possible.

The ground rules. With reference to the RPJM and the National Action on Clean Water, proposed interventions should be consistent with the following principles:

- In the short and medium run, PDAMs (with possibly some assistance from PPPs) will be the primary delivery mechanism for piped water services. It is not realistic to assume that communities would be able to mobilize the managerial skills and financial means to provide such services at the same price as properly managed utilities, although there may be openings for the management of small units (IKK).

- Long-term debt is necessary for utilities to finance the required investments. Loans from multilateral and bilateral financial institutions will therefore become the most important source of financing for the planned improvements in service delivery, in accordance with the NAP-CW.

- Private sector financing is a useful yet limited means to reach RPJM and NAP-CW targets, unless regulatory ambiguities are resolved. According to MPW, most PDAMs are not creditworthy and therefore not eligible for commercial debt finance.

- Optimization of the existing piped water supply systems is useful, but not sufficient to achieve GOI's targets for the piped water sector.

- Tariff and subsidy reforms must be an integral part of water sector policy reform.

- Improved governance and institutional reforms are necessary to reduce the number of PDAMs (most of which are too small to be commercially viable) through regionalization and to improve the professionalism of PDAMs and their local government owners.

Getting immediate results. In order to increase access and sustainability of piped water supply services, and move towards achieving MDG #7, the following actions are proposed for immediate attention (refer to the Attachment for details):

Provide incentives to local governments to reform PDAMs

- Develop objective and transparent conditions of eligibility for central government grants and access to multilateral and bilateral support for urban and rural water supply, linked to achieving pre-agreed financial and technical performance levels, and to improved governance and institutional arrangements.

- Raise awareness of decision-makers in local governments about the necessary reforms and the benefits to be derived from well-run service providers with expanded coverage.

- Raise awareness of existing and potential consumers by supporting public disclosure of efficiency indicators to make PDAMs more accountable to their customers.

Facilitate access to long-term financing to PDAMs

- Re-open the multilateral/bilateral lending window for non-indebted PDAMs.

- Move quickly to restructure debts of heavily indebted PDAMs to allow them to access multilateral and bilateral support, with meaningful penalties linked to intercepts of inter-governmental transfers for not delivering on agreed financial work-outs.

- Revise PMK 107, which regulates rescheduling of PDAM arrears. As presently written, PDAMs which re-schedule arrears would not be able to implement new donor-funded investment until 2011 at the earliest, thus compromising any possibility of achieving MDG targets.

THE WORLD BANK

- Provide OBA-funded incentives to moderately indebted PDAMs owned by local governments that are willing to repay outstanding arrears on PDAM and non-PDAM central government loans.

Encourage improved oversight and leadership by the central government

- Create a sense of urgency and demand for reform through broad, coordinated and consistent political support for the water sector, matched by actions in line ministries.

- Collect recent and reliable PDAM data and design sound methods for evaluating and disseminating information about PDAM performance.

- Discontinue central government support for water supply to local governments that claim PDAM dividends (unless the PDAM already meets MDG#7 targets)

Create a conducive climate for private sector investment

- Amend PerPres 67/2005 to remove legal uncertainties concerning the scope, available sources of funding and relation to KepPres 80/2003.

- Spin off existing small-scale piped water supply systems (IKK) from PDAMs through assignment to a local government department, BLU or privatization.

ATTACHMENT Action Plan for Providing Affordable Piped Water Services (2007)

Policy Measure	Actions to be taken
Provide incentive to local governments to reform PDAMs	Develop objective and transparent conditions of eligibility for central government grants and access to multilateral/bilateral support for urban and rural water supply, linked to achieving pre-agreed financial and technical performance levels, and improved governance and institutional arrangements.
	Raise awareness of decision-makers in local governments about the necessary reforms and the benefits to be derived from well-run service providers with expanded coverage.
	Raise awareness of existing and potential consumers by supporting public disclosure of efficiency indicators to make PDAMs more accountable to their customers.
Facilitate access to long-term financing to PDAMs	Re-open the IFI lending window for 'non-indebted' PDAMs.
	Restructure debts of heavily indebted PDAMs to allow them to access multilateral and bilateral support, with meaningful penalties linked to intercepts of inter-governmental transfers for not delivering on agreed financial work-outs.
	Revise PMK 107 and provide OBA-funded incentives to moderately indebted PDAMs owned by LGs willing to repay outstanding arrears on PDAM and non-PDAM central government loans.
Encourage improved oversight by the central government	Collect recent and reliable PDAM data and design sound methods for evaluating and disseminating information about PDAM performance.
	Discontinue central government support to LGs that claim PDAM dividends (unless the PDAM already meets MDG#7 targets) or own a PDAM that charge tariffs less than 50% of full cost-recovery levels or does not have a credible and sustainable water loss reduction program.
Create a conducive climate for private sector investment	Amend PerPres 67/2005 to remove legal uncertainties concerning the scope, available sources of funding and relation to KepPres 80/2003.
	Spin off existing IKK from BNA kabupaten PDAM through BLU, privatization or assignment to Dinas PU

Output	Target date	Executing Agencies
Implementing guidelines to improve APBN targeting, and dissemination to local governments (LGs).	Sep 2007	MoF (BAPPEKI), MPW
Awareness raising campaigns completed (via national associations such as APEKSI, APKASI and ADEKSI). Assistance provided to interested LGs.	March 2007	MoHA
Commence pilot project to establish public information centers in 10 LGs. Establish MoHA website with recent and reliable PDAM data.	Dec 2007	MoHA
Preparation of at least two IFI-funded piped water supply projects started. DPPP records publicly available on MoF website.	July 2007 / Jan 2007	MPW, MoF
Debt workout completed for 5 heavily indebted PDAMs owned by reform-minded LGs.	Dec 2007	MoF
Revision to PMK107 issued, including detailed implementing guidelines. Debt workout completed for 10 moderately indebted PDAMs owned by reform-minded LGs.	July 2007 / Dec 2007	MoF
Recent and reliable BPKP data and PDAM performance indicators publicly available. Proper PDAM evaluation method available.	Sep 2007	MoHA
Implementing guidelines to improve APBN targeting, and dissemination to LGs.	Sep 2007	MoF (BAPPEKI), MPW
Amend PerPres 67/2005 or issue detailed implementing guidelines.	July 2007	Secretary of State
GOI-approved strategy on PDAM consolidation.	Apr 2007	MoHA, MPW