



The eve of de-privatization in Jakarta series 3

# The Unfair Cooperation Agreement on Water Privatization

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**P**rivatization of water services in Jakarta has been problematic since the cooperation agreement was signed between PAM Jaya, a state-owned water utility, and the two private operators, Palyja and Aetra. Issues brought about by this document include PAM Jaya's mounting debts, poor water services and high water tariffs. While the cooperation agreement guarantees the private operators' profits, it makes PAM Jaya and the residents bear the losses of the private operators' high costs.

The cooperation agreement on water services privatization was first signed on July 6, 1997 and became effective on February 1, 1998 for a 25-year period. To adjust to the new situation after the political and economic crisis in 1998, the cooperation agreement was amended and restated on October 22, 2001.

Because the private operators' performance did not improve and PAM Jaya continued to suffer from major financial losses, a contract renegotiation took place. In December 2012, Aetra agreed on some renegotiated points that have been included as an addendum, while Palyja still refuses to modify the agreement altogether. However, the renegotiation has failed to change the cooperation agreement itself.

One of the problems posed by the cooperation agreement is the emphasis on private operators' profits. The payment mechanism from PAM Jaya to the private operators adopted in the cooperation agreement is called the "water charge". The tricky part is that the water charge is not related to the water tariff, which PAM Jaya

collects from water users. Article 28.1 states that the initial water charge as of April 1, 2001 was Rp2,400, and would be adjusted every six months; this creates a structural problem, however, because PAM Jaya does not have a similar flexibility in increasing tariffs because most residents cannot afford it.

The water charge can be raised liberally without considering the water tariff policy and guarantees the private profits. For PAM Jaya, every water charge increase that is not followed by a parallel water tariff increase leads to a financial shortfall. This led the government to issue a policy that allowed raising the water tariff automatically every six months, effective from July 23, 2004 to 2007. Not surprisingly, Jakarta's water tariff has become the highest among other big cities in Indonesia.

The revenue from water tariff is divided in accordance with Article 28. PAM Jaya's revenue is calculated based on monthly costs, payment of debts to the Ministry of Finance, the Regulatory Body's costs, and the share of revenue for the Jakarta provincial government. However, this provision does not by itself provide benefits for PAM Jaya because, if the entire revenue cannot cover the private operators' water charge, PAM Jaya has to bear a shortfall, or the difference between the water tariff and the water charge.

## **Private operators and service performance**

The initial purpose of involving the private sector in water services was to improve water services as mentioned in

Minister of Home Affairs' Instruction No. 21/1996. The cooperation agreement also stated in point 2.2 that it aims to develop the water infrastructure, improve distribution, ensure the quantity, quality, and continuity of water services, and reduce the water loss level.

Ironically, the cooperation agreement gives much leeway to the private operators in terms of the performance targets stated in clause 20 for Technical Targets and clause 21 for Service Standards. The regulation mechanisms on performance targets are weak, which makes it easy for the private operators to evade them. For instance, it is stated that they may be amended from time to time in accordance with the Financial Projections.

The quality of water services, which is highly dependent on the technical targets and service standards, is increasingly difficult to improve because the cooperation agreement provides the flexibility to adjust the targets. Private operators can propose a target adjustment if there is a problem of raw water supply (Clause 11). Technical targets and service standards can also be lowered if PAM Jaya fails to shut down the residents' groundwater wells in the area covered by the private operators' services (clause 12), as well as other situations that can justify adjusting performance targets.

The cooperation agreement's leniencies on the private partners' performance targets have made water services hard to improve, and in turn has victimized families. It gets worse because the private operators keep failing to reach the target even after they have been lowered.

### **Private operators' business interests**

The provision in the cooperation agreement that protects the private operators' interests can be found in clause 27 on Financial Projections. Financial Projections

determine the price of the water charge. Private operators are guaranteed to get profits because any uncontrolled factors are included in the calculation of the water charge, such as inflation, currency exchange and interest rate fluctuations.

Normally, companies have to pay a certain amount of money for hedging to anticipate exchange risks. In this case however, the private operators are not only freed from risks but also can gain from exchange rate fluctuations. Likewise, if there are changes in tax rates, the water charge is adjusted by taking into account any loss suffered or profits earned by the private operators (clause 38.5).

In addition, in the event of an emergency that requires particular measures (e.g. in case of drought), all costs and expenses incurred by the private operators are recognized as PAM Jaya's debt to them (clause 36.2).

The cooperation agreement even guarantees the private operators that they will earn a profit equivalent to 22% of the Internal Rate of Return (Clause 27.1). This return is too high, especially when it is compared to the recommendation from the Financial and Development Supervisory Agency (BPKP) that the reasonable rate for water services in Jakarta would be 14.68%.

Although the cooperation agreement has caused numerous problems, terminating it before its expiry date would force PAM Jaya to pay a high penalty (Clauses 41, 42 and 43). Whether the termination takes place due to force majeure, unilateral termination by PAM Jaya, unilateral termination by private operators, or termination through share repurchase, PAM Jaya will bear the costs.

This is a cooperation agreement that gives the private operators a guarantee of maximum profit at minimum business risks and it makes PAM Jaya and the public responsible for the massive losses while continuing to receive poor water services.