Indonesia

Sustaining the commodity dividend

INDONESIA IS REAPING THE BENEFITS OF SURGING GLOBAL PRICES FOR ITS ABUNDANT NATURAL RESOURCES. AT 6.3%, ECONOMIC GROWTH LAST YEAR WAS THE STRONGEST IN A DECADE. TO MAINTAIN MOMENTUM, RESOURCE SUPPLIERS ARE MOVING UP THE VALUE CHAIN. AND THE GOVERNMENT IS FOCUSED ON AMBITIOUS INFRASTRUCTURE DEVELOPMENT.

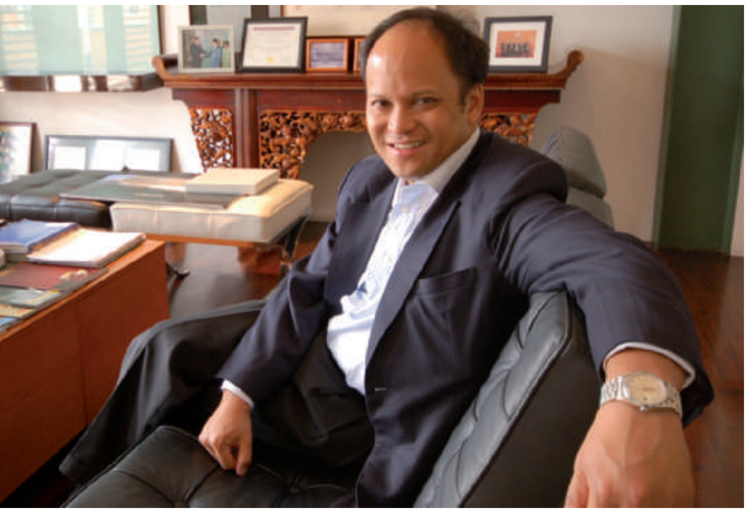
Since the dawn of the spice age some 500 years ago, Indonesia has been blessed with an abundance of natural resources that are desired by the world, including oil, natural gas, timber, palm oil, rubber, tin, copper, gold, and other minerals. But in the past, Indonesia has had trouble converting its natural resources into the kind of sustainable economic growth that can benefit both businesses and the country itself.

With commodity prices sky high, and world demand soaring, Indonesia is once again in a position to derive countrywide economic benefits from its surplus of resources. The stars appear to have aligned perfectly: prices are high for many of its key commodities, especially oil, natural gas, and tin; and with demand rising, and supply more or less steady, prices are likely to remain high for the foreseeable future. And because its main commodity export customers are in booming Asia, particularly China, Indonesia is insulated from the economic slowdown that has hit developed markets.

At the same time, the country has entered a period of relative political stability that should further boost the fortunes of established commodity producers. The government has moved to shut down rogue mining, oil drilling, and logging operations, an initiative that not only reduces supply, but also provides opportunities for established companies to take over the operations of illegal producers.

"Of the positive factors, I think first of all the political situation has been rather stable, and there have been a lot of successful examples [of good government] at both national and regional levels," says Ilham Habibie, CEO and President Director of Ilthabi Rekatama, a conglomerate that is active in manufacturing, financial services, and property, and most recently in natural resources, such as coal. "And second," he says, "would be Indonesia's unique position as a natural resource-based country between large growth areas such as Southeast Asia, India, and China."

In an effort to spread the benefits of its raw material production, the government has taken steps to push commodity exports further up the value chain. Rather than shipping raw tin, tin ore, logs, oil, and other natural resources out of the country, Indonesia is working to produce and export more refined, labor-intensive products. Because it has relatively low labor costs and a large, willing work force, adding value to commodity exports is a natural progression.



Ilham Habibie (above) CEO and President Director of Ilthabi Rekatama. Wachid Usman (right) President Director of PT Timah.

But some commodities are more likely than others to deliver a long-term, sustainable boost to the economy. The country's leading exports are, in order: oil and gas, minerals, electrical appliances, rubber products, and textiles. Exports of oil and gas surged more than 60% in the first quarter of 2008, compared with the previous year, and the country has significant reserves.

In addition, the lifting costs in Indonesia – the price of getting oil and gas out of the ground – are comparatively low, says Habibie, while the probability of success is relatively high. "Indonesia has a lot of hydrocarbons. The question is, of course, how much?" he asks. "There are quite a few large fields to be found here, like Cepu in Central Java, and Natuna (islands, near Kalimantan), and the gas field in Irian Jaya. These three are really major in terms of gas, some seven, eight, nine trillion cubic feet; they are truly big," Habibie says.

Nonetheless, oil and gas exports are unlikely to provide a broad surge to the economy, because the country's 236 million people consume so much of the total output. Indonesia has become a net importer of oil, while natural gas accounts for less than 10% of its exports. And as oil prices rise, domestic inflation rises as well, which handicaps GDP growth and tends to offset the gains achieved by the oil and gas that is sold overseas.

When it comes to delivering sustainable growth, a more promising product is tin. Indonesia is the world's number two supplier, behind China. Tin lends itself to value-added production, and exports are likely to remain high as only about 10% of the country's tin output is consumed domestically. China's entire production, by contrast, is used inside the country.

The country is also home to the world's largest tin producing company, PT Timah, an integrated company that has operations in all facets of the tin industry, from exploration and mining to smelting and marketing. Some 95% of the company's tin is exported, mostly to Japan, Korea, Taiwan, China, Singapore, and Europe. "If you ask about our markets, they are mostly in Asia," says Wachid Usman, President Director of PT Timah. "About 55% goes to Asia, 30% to Europe, and about 8% to North America. The domestic market is very small."

Because of its relatively low land and labor costs, and low taxes, Indonesia should be able to produce finished tin products cheaper than its competitors, says Usman. "Right now, many of our customers are buying tin ingots to change into products that are used in their industries," he says. "We are sure that if these products were made in Indonesia, those tin users would get a better price.

"With tin prices so high," Usman continues, "our customers will try to be efficient in their product usage. That's why we got the idea of downstream business, to serve the existing market. Right now what we serve is just tin ingots, but in the future we will develop downstream products like solder tin and basic tin chemicals," he says.

Indonesia's tin industry has also benefited from tightened government regulation. Starting in 2006, the government began to crack down on the unlicensed mining of tin, which reduced global supply. At the same time, export regulations were strengthened in a bid to prevent illegal exports. "Since the end of 2006 when the government [improved regulation of] tin mining activities in Indonesia, it created a better situation and also reinforced the importance of Indonesia in the global tin business," says Usman.

At the same time, demand got a boost from the use of new solders, as electronics manufacturers increased their use of tin, in place of poisonous lead solders. As these forces converged, world tin prices soared, from $6,000 per ton in 2005 to $9,000 in late 2006 and $14,000 in 2007. Prices eventually reached an all-time high of more than $25,000 per ton in May, before retreating slightly. Buoyed by rising tin prices, PT Timah's profit rose seven-fold in 2007.

Encouraged by its success, and by high commodity prices, PT Timah has increased its exploration activities, and has expanded its business to include gold, manganese and nickel. The company has also turned to coal – in 2004 it acquired a coal company and it now ships to Japan, Korea, the Philippines and other markets.

As the world's largest exporter of tin, Indonesia is well positioned to reap long-term benefits. "I hope the tin mining sector will become a mainstay that the government can rely on, a contributor to state income that it is able to develop and improve the overall economy," says Usman.

Although the developments are promising, Indonesia faces substantial hurdles in its struggle to convert its natural resources into sustainable growth. A lack of infrastructure remains a serious problem, says Usman. "It is important that infrastructure is developed in the areas where we operate," he says. "There is still a lack of infrastructure, especially electricity and water supply. We need that, but our capacity to provide it is very limited, so we believe that it has to be developed by the government." ■ *BY BRENT HANNON*

APRIL: Leading the way in sustainable forestry

Indonesia is blessed with forestry resources that few countries can match. Ideal climatic conditions that deliver a year-round planting season further reinforce that advantage.

As a result, Indonesian companies have become major players in the global pulp and paper industry.

But in this business, market share is not won simply through higher yields or a production advantage. Customers around the world demand that their paper is produced sustainably, and with a positive impact on local communities. Indonesia's Asia Pacific Resources International Holdings Ltd., or APRIL, which operates one of the world's largest pulp mills in Riau Province, Sumatra, is leading the way in producing pulp and paper in accordance with the highest environmental and social standards.

Since operations began in 1995, APRIL has introduced global best practice in corporate governance and environmental sustainability, including signing up to the UN Global Compact and the World Business Council for Sustainable Development. The company protects those forests in its plantation areas with "high conservation value" designation, and works closely with the World Wildlife Fund to protect vulnerable wildlife. It also strives to combat illegal logging.

APRIL has built schools and clinics in its plantation areas, has introduced electricity, water supply and sanitation, and is working with local NGOs on a Poverty Elevation Campaign to bring locals above the poverty line.

As a result, says A.J. Devanesan, APRIL's President and COO, "in a survey conducted by the University of Indonesia two to three years ago, we found that people living around the area were 50% better off economically than those living outside it. We see growing trees as a very good business. Every 100 hectares will create 30 to 35 jobs. And it's good for the environment, if it's done in a responsible and sustainable manner."

Demand for the company's products is rising rapidly, especially in Asian markets, notably China. APRIL has already planted some 300,000 hectares of acacia, and it plans to add a further 70,000 to 80,000 hectares to meet its target of supplying nine million tonnes of plantation fiber a year by the end of 2009.

Sustainable forest management is a major factor in the company's success, Devanesan says. "We are committed to benchmarking the best, and doing as good or even better. This started right from the beginning, we were early adaptors of best practice," he says. "We'd like to be the industry leader, both in terms of size and best practices." ■ *BY MARK BERESFORD*

Smart building

A far-reaching program of infrastructure development aims to underpin the country's robust economic growth. Power projects are a priority.

Indonesia is doing well out of the global commodities boom. Rising prices for its oil, coal and gas exports are contributing to annual GDP growth of over 6%, bucking the global trend. In order to sustain that growth, and to meet the needs of the Indonesian people, the government is committed to bringing the country's infrastructure up to speed.

It faces a formidable task in a country of some 236 million people that sprawls across 17,000 islands, 6,000 of them inhabited, and three time zones. The task is made greater still by the fact that Indonesia neglected its infrastructure development for well over a decade following the Asian financial crisis of the late 1990s, and now has to catch up in every sector from power generation and roads to ports, airports and telecommunications.

"Everybody knows that the infrastructure in Indonesia is underdeveloped," says Musyanif, President Director of PT Pembangunan Perumahan (PP) General Contractor, one of the country's leading construction companies with experience in infrastructure development from hydroelectric power plants to ports, bridges, high-rise buildings, housing and hotels. Among the company's current projects are the constitutional court complex in Jakarta and a new airport for Medan. "For example, we have just 600 kilometers of toll road and we actually need about 1,500 kilometers," he says.

Indonesia faces more serious strains on its power supply. It currently has an installed capacity of 26,500 MW, and while it isn't facing the blackouts that hindered China, India and the Philippines in the 1990s, many of its power stations are aging and inefficient, and the main Java-Bali grid that handles 17,500 MW is under pressure.

Overall, the country needs an estimated $14 billion annually for infrastructure investment. Although the government has boosted spending, it can still provide only a small share of the total, forcing it to turn to private investors. Ideally, the government would like companies to join private public partnerships (PPPs), but investors have been slow to commit to projects in Indonesia for a range of reasons. These include comparatively high labor costs and, for local companies in particular, the reluctance of local banks to lend to the construction sector.

Musyanif says the biggest obstacle is legal uncertainty. "If a minister changes so does policy, and laws keep changing so investors don't have certainty," he explains. Government policy fluctuations over the past decade support his view. Prior to the financial crisis, for example, the country had 26 PPPs under development. They were all cancelled and it took the government until 2003 to settle the legal issues, at which point the economy began to pick up and by 2005 it was looking for PPP deals once again. It had little response, and in May 2006 it tried to sweeten the deals with a decree that allowed it to share in their political, project and performance risk.

Rapid economic growth has prompted a construction boom.

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Despite the many challenges, Sonny Purnara, Director of Dalle Energy, sees solid prospects for foreign companies in Indonesia, a fast-growing, commodity-rich economy with a significant domestic market. “There is a good chance for engineering, procurement, construction (EPC) players to start business in Indonesia, especially in energy and then in other infrastructure,” he says. And while recognizing previous problems, he sees the current government as an asset in attracting investors: “The government now is more consistent than the previous one.”

Purnara says Dalle Energy, which supplies specialized services in engineering, procurement, construction and commissioning for facilities and plant development, is keen to move further into independent power projects. “Our target is IPP, rather than EPC. We are starting with a small project and we are looking for partners for the larger projects,” he says. But he accepts that the government had to start with EPC projects in order to secure investor involvement.

Government efforts to liberalize the energy sector faltered when a law ending the monopoly on energy sales and distribution of state electricity company PT PLN, and allowing foreign companies to build power stations and sell directly to the public, was thrown out by the constitutional court in 2004.

PLN is following a traditional financing route for its $4.8 billion program to add 10,000MW to Indonesia’s power-generation capacity by 2010. In January, it announced that it had secured a $1.9 billion loan for five new coal-fired power stations. The company also has five hydroelectric plants and a 60MW geothermal plant under construction. Dalle Energy’s Purnara is happy to be part of this diversification process. “Our focus is on power plants and they can be gas, coal, or geothermal,” he says. “It is better to be specific, to focus on a niche.”

It’s a growing niche, the government wants to boost capacity by a further 6,000MW a year into the future. Purnara sees vast potential in geothermal power: “With 30,000MW of potential, Indonesia could be No. 1 in the world.”

Musyanif sees improvement in some areas, notably in the government’s willingness to allow greater flexibility in areas such as tariff setting, the length of concessions and land-purchase arrangements for toll-road projects, and he says PP General Contractor is gearing up for more business. “We are looking to the future, first to the many infrastructure projects in Indonesia and then to the Middle East,” he says. “We have been sending our staff overseas for training for the past 10 years, we have worked with British, Japanese and Chinese companies and we are planning an IPO this year which will make our business three to four times larger.”

■ *BY PAM DOUGHERTY*

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