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The Market Turn in Jakarta's Water Supply: Vested Interests and Challenges of Realising the Regulatory State

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Market-building, particularly in network industries, has been a common practice in many developed economies over the last few decades. Following the abandonment of Keynesian interventionist state norms situated around the state provision of public services, especially in electricity, water, energy and transportation services, and the adoption of New Public Management (NPM) agendas predicated on the private provision of public goods, numerous countries adopted privatisation measures which effectively devolved state monopolies to private sector owners and operators. The United Kingdom, France, Germany, Canada, Australia, New Zealand, among others, led the way with reforms that unbundled network industries. While highly contentious, neo-liberal policy reforms gained a popular following and were often invoked as a means of correcting what were seen as "bloated" public sectors where unionised labour practices and poor customer service outcomes had led to sector inefficiencies and increasing fiscal burdens on state treasuries. Privatisation was thus seen as a means of reducing the fiscal burden on the state while, at the same time, introducing market rationality that would discipline network operators, incentivise the adoption of efficiency measures and the efficient utilisation of financial resources. At the same time, with the adoption of appropriately designed regulatory systems, these increased efficiencies could be mutually shared by operators and consumers alike creating a "win-win" situation for all stakeholders. Much of the 1980s and 1990s thus witnessed the progressive adoption of neo-liberal privatisation measures with the aim of constructing markets to support private sector investment into the sector (see Carroll 2012a; Jarvis 2012).

While such marketising strategies were widely and often vigorously adopted in industrialised economies, the outcomes they produced were uneven. Issues associated with regulatory capture, poor regulatory design, contract renegotiation, as well as large increases in user-pay costs and disputes over the capture and distribution of efficiency gains highlighted the complexity of NPM models for the provision of public goods and services. Indeed, despite these problematic outcomes and the complex governance issues associated with neo-liberal market-building activities, some of which resulted in outright market failures, this did not stall such initiatives or deter their policy adoption in developing economies. Multilateral development agencies like the World Bank, Asian Development Bank and the International Finance Corporation, among others, continued to champion neo-liberal policy agendas, seeing privatisation and the private operation of network utilities as instrumental reforms necessary to overcome poor state capacity and persistent fiscal constraints endemic in many developing economies. In Asia, for example, Thailand, the Philippines, Singapore, India, Indonesia, China and Malaysia~~,~~ all experimented with privatisation measures and market-building activities in network industries, attempting to set in place the appropriate regulatory and sector designs that would facilitate private sector participation while freeing-up finite state fiscal resources for more pressing developmental needs.

This chapter explores one such attempt at neo-liberal reform and market-building in the water sector in Jakarta, Indonesia. The privatisation of Jakarta's water utilities started out with much optimism and fanfare – the hope of efficient, cost-effective services, water for all and a sorely needed injection of investment into the city's rapidly aging water infrastructure. As one of the poorest performing sectors in the Indonesian economy, poor water coverage, the limited availability of potable water and persistent under-investment in the sector due to insufficient state fiscal capacity had left the sector with long wait times for water connections, insufficient water pressure to ensure reliable distribution, and haphazard planning and maintenance that led to frequent breakdowns and long-term water outages across many of the city's suburbs. Compounding the situation was Jakarta's rapid population expansion. As the commercial centre of Indonesia, the greater Jakarta metropolitan area now comprises over 27.9 million people, while the capital city of Jakarta has grown to almost 10 million people. As the city's population continues to expand annually at around 3.6 per cent, the strain on water infrastructure and the demands for ever more connections continues to rise (Firman 2011). For a developing country rife with infrastructure problems, the introduction of private water concessions was designed to rectify these mounting problems and provide the necessary investment to support one of Asia's largest and most rapidly growing megacities.

Almost two decades after the introduction of private water concessions, however, Jakarta customers have poorer service than before, private operators have fallen short of their profit targets, while the fiscal liabilities of the Indonesian state for shortfalls on the rate of return contractually obligated to private operators has progressively escalated to tens of millions of dollars.

What commenced as a promise of a revitalised, efficient and service focused reform effort has actually resulted in worsening sector outcomes. By 2012, for example, only about 43 per cent of Jakarta's households enjoyed water connections, and of these households water services are available only about two-thirds of the time. Worse still, non-revenue water now stands at a staggering 50 per cent, with illegal connections ravaging the system, lowering system-wide pressure and compounding revenue shortfalls in the sector. At the same time, water quality has deteriorated, with tap water unsafe to drink unless boiled before consumption, while in North Jakarta, home to some of the poorest city-dwellers, there are frequent reports of public health problems such as cholera and other water-borne diseases. Perhaps most alarming of all, however, since the introduction of private water concessions in Jakarta, the price of water in one of the world's poorest cities (in terms of average GDP per capita) is now among the highest in Asia, only surpassed by the price of water in Singapore and Hong Kong – two of the region's richest economies (Bey and Trapp 2009). For the vast majority of Jakarta's poor, water has become too expensive a commodity to purchase and too dangerous to consume.

This chapter traces the story of market-building in the water sector in Jakarta, mapping the "ideological shift from politics towards the market" (Pierre and Peters 2000: 55) to embed markets into state utilities. As this chapter notes, this effort was driven largely by two forces – internally, there was a wave of political ferment demanding changes in Indonesian governance, greater accountability and better provision of essential services – particularly for Indonesia's poor and marginal communities. At the same time, external pressure for water privatisation came from the World Bank, which for several decades impressed upon developing nations the importance of involving the private sector in utility provision in order to overcome state fiscal constraints and rapidly expand water infrastructure. As the chapter notes, the key ideas underlying the privatisation of Jakarta's water supply were based upon neo-liberal assumptions of the political and economic benefits derived from harnessing market forces and aligning these to a developmental agenda. In doing so, the hope was for a transition from a governance system based on patronage and political connections to a policy-making environment and set of processes that were insulated from political interests and driven by market rationality and efficiency.

This chapter details how these assumptions were invoked at the outset of the privatisation process, and traces the attempt to realise the benefits accorded to markets through particular contractual and regulatory outputs associated with the "regulatory state". As the chapter also notes, however, these broad elements are not just formal institutional arrangements comprised of legal contracts and partnership structures, but also of *informal* norms and values which ultimately serve as legitimation devices that support regulatory forms of governance. But, as the chapter also demonstrates the very institutional forms that were supposed to curb political opportunism, boost public service capacity and improve access to public utilities actually worked to the reverse.

The findings of this chapter are related, but not wholly identical, to critiques of neo-liberal agendas about the role of markets and the relationship between states and markets (*inter alia*, Haughton 2002; Bakker 2003; Goldman 2005; McDonald and Ruiters 2005; Carroll 2010). By contrast, this chapter takes a more discursive lens to the problem by framing the market-building effort in Jakarta as part of the movement towards realising a regulatory state. The chapter thus reflects the thinking of Craig and Porter (2006) who argue for "heterodox solutions" as a departure from the market-embracing neo-liberalist agenda. A balance is needed, they argue, to the dominant "unrealistic Liberal, market-oriented hopes around allocative efficiency, service delivery and consumer voice". Such a heterodox approach would involve stronger accountability relationships through better funding of government agencies and officials as well as "smart repoliticising". The heterodoxy required in Jakarta, I thus argue, can be revealed by using a regulatory state paradigm which allows us to have a greater appreciation of how the formal institutional structures react with, and are conditioned by, the social and political environment in which they operate.

Organisation of the chapter

The first section of the chapter gives a broad theoretical overview of the reforms within the neo-liberal movement and the search for a new form of governance that was to coalesce around concepts of the "regulatory state". The second section translates these ideas into the Indonesian context, including the adaptation of the global rhetoric of neo-liberalism and the regulatory state and how both were used to champion local political decentralisation in Indonesia, an outcome that both enabled and deepened, ironically, the role of political patronage at the expense of emergent forms of regulatory governance. The analysis covers events over the past two decades leading up to the current financial and operational crisis facing the current Jakarta administration. Further, this section also outlines how the attempt to realise a regulatory state was confounded by the introduction of key market-making institutions; specifically, the flawed design of the concession contracts, the constituting nature and impaired operational capacity of the regulatory bodies, and the adoption of ad hoc mediation procedures for the resolution of disputes between the state and concessionaires.

In the second section, the chapter addresses the failure to transition successfully to regulatory modalities of governance, and argues that this failure is a product of the specific characteristics of embedded social relations in Indonesian, that is, the unique and patrimonial nature of social, economic and power relations that pervade the Indonesian state, state-market relations and private economic activity. As the chapter argues, these socio-political and economic forms of patronage derailed the realisation of independent, technocratic, impartial and politically insulated institutions demanded by regulatory modalities of governance, effectively stalling the prospects for formalised markets to emerge in ways that would be sustainable. As the chapter notes, the nature of patronage in Indonesia is such that while the formal institutions appear to be in place, the informal norms and values that impact governance and condition social relations remain unchanged.

The privatisation debate: market-building in the regulatory state

A large part of government activity and institutional change in the last few decades of the twentieth century can be ascribed to the rise of neo-liberalism (Berger and Dore 1996; Boyer and Drache 1996; Crouch and Streek 1997). Broadly, this has meant three things: market deregulation, state decentralisation and a reduction in the size and role of the state in economic affairs (Lash and Urry 1987; Albert 1993; Przeworski 1995; Jarvis – this volume).

In this it finds traction within a larger dialogue associated with the modernisation school, including Keynesian theories and the Washington consensus of the 1980s and 1990s, where the process of development was surmised to be *technical* and largely *a*political. In the 1990s, with the rising interest in governance, the regulatory nature of state authority became a focal point, in particular the ability of the state to shape and facilitate the operation of markets (Hout and Robison 2009). Markets could deliver public utilities it was increasingly thought if only the state learnt how to govern them properly and only if states learnt how to set in place those conditions, rules and procedures that would create enabling environments for markets to establish and thrive.

The history of "governance" and governance innovations in the late twentieth century was thus as much about setting in place the rules by which markets would operate in newly created commercial domains as it was about getting states "out of the way" of markets and allowing markets to do what they do best: seek out profits and returns on capital through the provision of goods and services. That various states learnt these governance lessons is borne out by the growth in private sector participation in all facets of economic activity over the last few decades. Empirically, for example, we find more non-state actors, including private sector groups, taking part in public life (Rosenau and Czempiel 1992; March and Olsen 1995; Peters 1996; Rhodes 1997; Lynn and Ingraham 2004). As Kettl observes, the forces transforming governance such as "the diffusion of administrative action, the multiplication of administrative partners, and the proliferation of political influence outside government's circles" (2000: 159) has provided policy learning and, in the process, the development of new governance tools for the management of markets. Dunleavy and Hood (1994) describe this new paradigm emerging along two lines – first the public sector is "less distinctive as a unit from the private sector" than it used to be historically, and second public officials work through a less dense grid of rules and regulations and have more discretionary powers. Such outcomes have, in turn, allowed for more flexible state-market arrangements, differing forms of authority structures, including new legitimisation processes, and different forms and systems of accountability and transparency (Garvey 1997; Kettl 2000). As a result, such governance innovations have precipitated the increasing use of third parties (Salamon 2002), seen as explosion in outsourcing of government services, or the outright withdrawal of government from service provision in some sectors. As the same time, these more flexible governance modalities have engineered what some have described as an absolute decline of hierarchy within government (Frederickson and Smith 2003).

As will be recognised, this new paradigm is not just an argument about the scope and scale of government, but also its basic forms (Jessop 1997; Pierre 2000). Part of this new paradigm consists of what the editors of this volume have termed "market-building" efforts. With reference to the provisions of public utilities, in the United States (Bardach and Kagan 1982) and in Europe (Majone 1994, 1997b; Moran 2003; Vogel 2003), this conversation has taken place within the discourse of the "rise of the regulatory state" a discourse that has now ascended to a dominant mantra and aligned with neo-liberal policy prescriptions.

What is a regulatory state? Regulatory discourse and legitimisation

In the regulatory state the concerns are mainly with the role of competition, markets and privatisation (Vogel 1996; Jordana and Levi-Faur 2004). Regulation as commonly understood today is a set of rules administered typically by an independent regulatory agency (IRA), which governs public behaviour and sets in place the procedures, processes and systems by which the sector operates, articulates the rights and obligations both of private actors in the sector but also those of government, and establishes the mechanisms for mediation in the event of disputes arising between stakeholders (commercial operators, consumers, government) (Baldwin et al. 1998; Braithwaite et al. 2007). Whatever definition is used, however, is to some degree immaterial since regulation might be better appreciated as a catch-all ideal whose motif is singular: the construction of an environment conducive to private sector participation – principally through the protection of property rights, guarantees of probity, stability in the rules that govern the operating environment and investor protection against government opportunism and nefarious political intervention. In essence, the ideal behind the regulatory state is, first and foremost, the de-politicisation of the sector and

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its commercial "normalisation" so that efficiencies associated with private sector activity can be channelled into the provision of public goods. Notions of regulation might thus be understood as technocratic attempts to supplant politics and replace inherently political processes with commercial and procedural norms.

Writing specifically on market-building efforts in the water sector, Mary Shirley, in a case study of six urban water systems, captures this notion of regulation and the reciprocity that the instigation of commercial norms instils not just among private sector operators but the governments who oversee them. As she notes, "contracting out water services to private operation may be most useful to countries with weak institutions. The concern of global operators with their worldwide reputations, local relationships and their responsiveness to the incentives under contract can propel improvements that would not have occurred under a public operator not subject to these motivations. Governments' concerns about its international reputation function more strongly when there is an international operator present…" (2002: 37).

In terms of market-building, the first legitimation device of the regulatory state is thus a straightforward one of capturing private sector efficiencies by creating governance systems that define and normalise commercial practices, build technocratic oversight processes and insulate the sector from politics.

A second legitimation objective of regulation arises from fiscal prudence. Regulatory governance arises out of a series of procedural and technocratic processes designed to capture fiscal efficiencies and deliver to consumers better, more responsive services delivered in the most efficient, cost-effective manner. The political debate about who should provide public services (the state versus private operators) is thus replaced by a "value for money" discourse premised on fiscal prudence, best use of tax-payers' money and notions of managerial efficiency: that whoever serves the interests of the community more effectively should take over the provision of such services. If commercial firms can serve this interest, there is no reason for the state to perform the same function. Indeed, under this rationality, the involvement of the state in the provision of such services is variously depicted as cost ineffective, managerially inefficient and less competent. On this view, politicians and bureaucracies do not have the time, expertise or capacity to design and administer complex policies, or oversee complex industries owned by the state. Special agencies, such as IRAs, with highly trained and expert staff, should be allowed to assume this oversight (Majone 1999). Salamon (2002), for example, argues that "problems have become too complex for government to handle on its own, because disagreements exist about the proper ends of public action, and because government increasingly lacks the authority to enforce its will on other crucial actors without giving them a meaningful seat at the table".

For a government with little financial resources, poor technical capacity and a mounting crisis in public utilities, as was the case in Jakarta in the late 1990s, fiscal prudence thus became an appealing means that both justified and legitimated privatisation of the water sector (World Bank 1997b: 1). Indeed, the World Bank supported both the push towards privatisation and forcefully articulated the fiscal prudence of privatisation measures.

A third legitimising rationale that supported the advent of regulation derived from the need to provide "credible commitments". Scholars locate this need in the alleged decline in public trust in major political and social institutions. As Moran (2000) notes, "we audit and we regulate, when we cease to trust". Majone (1999) argues this is the main reason for delegating policy powers to what he calls "non-majoritarian institutions" (non-elected regulatory bodies such as IRAs). As he observes:

> Under the expectation of alternation, democratic politicians have few incentives to develop policies whose success, if at all, will come after the next election. Moreover, because a legislature or a majority coalition cannot bind a subsequent legislature or another coalition, public policies are always vulnerable to reneging and hence lack credibility.

For Majone, "short-termism" has long been recognised as an intrinsic problem of democratic governance, where politicians drive policy in ways aligned with election cycles rather than in ways that deliver efficient, rational, fiscally prudent policy outcomes. In such an environment, however, the trust factor diminishes, governments and politicians change or reverse policy, political commitments are abandoned and the credibility of the public sector is reduced. In an era of increasingly mobile capital and interdependence, credible governmental commitments thus assume a heightened intrinsic value necessary for effective market-building. This is especially so in a regulatory state context, where much depends on the private investors' perception of the credibility of the government and, in turn, on the conduct of government and the regulator in terms of upholding the (contractual) commitments entered into. Save for positive perceptions of a government's credibility, mobile capital will invest elsewhere.

The case of Jakarta's water privatisation initiatives can be viewed as an attempt to realise these three key elements of the regulatory state: enhance private sector efficiencies in the provision of a public good, instil fiscal prudence as a cornerstone of service delivery and erect a governance framework that assured credible commitment in the sector in order to entice private investment. Indeed, these three key pillars undergirded the Jakarta government's approach to privatisation, providing not just an ideational framework for the move towards private investment in the sector, but a genuine belief that enjoyed widespread acceptance that beneficial outcomes for consumers, the government and investors would rapidly emerge. As Bremer noted of the move towards the privatisation of Jakarta's water:

> If water access is a right, as recently confirmed by the United Nations, then it is governments' responsibility to make water available as efficiently as

> possible... If mobilisation of private investment is the only way that water systems can be put in place to meet community needs, then governments have a duty to do precisely that. The question is not whether this option makes sense – it is the only option. (2003: 11)

Water privatisation, it was popularly believed, was about to solve the crisis of Jakarta's water, a crisis that was palpable among the city's residents (see also Ehrhardt 2000).

Jakarta: the market turn

Since 1922, Perusahaan Daerah Air Minum DKI Jakarta or PAM JAYA, the government's water company, operated Jakarta's water supply system (Lanti 2006). The outflow, or the resulting waste water and sanitation, operated under the purview of PALYJA. Amid rapid urbanisation and ever-increasing demands for more water provision and sanitation services, the strain on Jakarta's water supply system and its public utilities had been evident for over a decade, with the sector suffering from poor service quality and high water losses. By the late 1980s, these losses reached breaking point – the service coverage ratio, for example, was a mere 23 per cent while non-revenue water stood at some 51 per cent (JBIC 2001). By the 1990s and with ongoing urban expansion, less than half of Jakarta's population received water from the public supply. Rectifying this situation was going to require massive public expenditures and an urban works programme the likes of which few cities had experienced historically (Tutuko 2001).

Clearly, however, the infrastructure works programme for Jakarta's water sector was beyond the financial reach of the Indonesian government, particularly when coupled with competing financial demands from other domestic constituencies. In 1995 President Suharto thus ordered his Public Works Minister, Radinal Moochtar, to privatise Jakarta's water. Given the size and scale of the infrastructure deployment that was needed, it was decided to divide the city in half, creating two separate water sectors (West and East), each of which would be offered to private operators as separate concessions. By 1998, the government had contracted Jakarta's two water zones to Suez (from France) and RWE Thames (from the United Kingdom). Both were multinational companies, taking the Western and Eastern Sectors, respectively, with 25-year concession contracts.

The tender process and "birth defects" in contracts

One of the most distinctive aspects of the privatisation process concerned the award of the concessions. Typically, due process involves the award of concessions on the basis of competitive bidding in an open and transparent process. Atypically, however, both of Jakarta's water concessions were awarded via negotiation and behind closed door discussions that were not subject to scrutiny by an independent party. Indeed, the negotiation of the concessions was a highly political affair, even involving the President himself. In the case of the Eastern sector, for example, the negotiations went on for two years from 1995 to 1997, until Garuda, the local partner of Thames, bought the case directly to the Governor of Jakarta to try and achieve contractual closure. Garuda argued that "technically speaking, there were no fundamental problems to be solved by the negotiating team and the private party" (Letter to Governor, 14 April 1997, cited in Boomgaard 2007: 303) and urged the Governor to intervene and speed up the process. By contrast, the government raised issues about expenditure projections and the rate of water infrastructure deployment, manpower and staffing levels, and sundry other contractual issues. Extraordinarily, these issues were raised at the Presidential level, with the President then appointing a Minister who took over the negotiations, travelling to London himself to discuss the issue with Thames water. In turn, the Minister responsible formed a negotiation team to deal with the two companies consisting of representatives from the Jakarta administration as well as PAM JAYA . While the PAM JAYA representatives openly acknowledged concerns about the terms of the concessions, the concessions were concluded and the contract closed on 7 June 1997 amid political pressures to reach closure.

Further, and of most concern, questions about the probity of the award of the concessions were raised since both concessionaires were companies known to have close ties to the President. The London-based Thames Water Overseas Ltd, for example, had formed an alliance with Harjojudanto, the eldest son of the President, who held one-fifth of the company. Thames explained its decision in strategic terms, noting that "at the time, any company dealing with Indonesia would have to deal with some element of the Suharto family because of the way the government was set up" (Peter Spillett, head of environment, quality and sustainability for Thames as quoted in Harsono 2005).

Similarly, the other concession held by Suez had formed a close working relationship with the Salim Group, at that time the largest conglomerate in Indonesia, to negotiate and operate the Western concession. Sudono Salim, the founder of the Salim Group, was a close political ally of President Suharto and known to have privileged access. Indeed, political access in the case of concession negotiations was openly acknowledged by Bernard Lafrogne, a Suez representative in Jakarta, who noted that "access to politics is essential. The water business is always political" (Harsono 2005).

Regardless of the questionable process leading to the award of the concessions, however, privatisation of Jakarta's water proceeded. On 1 February 1998 the assets of PAM JAYA including the network and treatment plants and related equipment were transferred to the private operators on the understanding that they would be returned to PAM JAYA at the end of the concession period on 1 February 2023 (PALYJA 2005).

Birth defects: contracts, negotiations, and the devil in the details

As Andrew McLernon, an urban development consultant for the World Bank observed, from the outset the process and design of the concessions suffered from "birth defects" – a lack of transparency, the failure to raise water rates prior to privatisation and the lack, initially, of an independent regulator made for a malformed set of governing instruments. These failures in contract and regulatory design, however, should be contextualised amid a palpable state of crisis in Jakarta's water sector, where popular pressure for political intervention to fix Jakarta's water problems invited political intervention at the highest levels, in the process creating a space for ill-conceived contractual design, the absence of regulatory oversight or the identification of regulatory mechanisms for dispute resolution. Indeed, emblematic of these "birth defects" was the fact that while the privatisation effort was initially supported by the World Bank, when it realised that the contracts were to be awarded on a non-competitive basis, it dropped support of the project (World Bank 1997b: 177).

The details contained in the concession contracts also reveal much about the inevitable legacy such privatisation measures would have on the sector. Several weaknesses were immediately apparent in the contracts and, indeed, would come to hinder the development of the sector.

First, the contracts provided for a "water charge". This was to be paid to the water companies by PAM JAYA. The water charge was essentially a guaranteed revenue stream paid annually to the concessionaires. It was designed to ensure the concessionaires would receive a contractually agreed internal rate of return (IRR) of 22 per cent annually for the life of the contract (25 years). From the position of the concessionaires, the water charge was set in place to offset what they argued would be revenue shortfalls due to the large incidence of non-revenue water (illegal connections), water tariffs that were set at below the cost of water provision and the infrastructure roll-out that would be required to address both the decayed state of existing infrastructure and the rapid expansion in Jakarta's population (new connections). The water charge and the agreed IRR of 22 per cent thus provided the concessionaires with a gold-plated, guaranteed return, devolving financial liability in terms of revenue shortfalls to the government.

Second, the mechanisms for revenue and tariff management were cumbersome, burdening financial liability on to PAM ~~Jaya~~ rather than the concessionaries. Under the terms of the concessions, for example, PAM ~~Jaya~~ was to pay the water charge guaranteed to concessionaires from revenues generated by the water tariff paid by consumers. While the tariffs would be collected by the private operators of the concessions, the concessionaires would deposit tariff revenues into an escrow account. In theory, the monies would be sufficient to pay for the water charge, as well as pre-existing debts and payments to the city government. In practice, however, PAM ~~Jaya~~ was to find that the tariffs collected were not sufficient to pay the water charge, partly because of the difficulties of raising tariff rates due to concerns about affordability, equity and political intervention. Indeed, subsequent discussions on tariff rate rebasing proved to be an arduous process, effectively creating mounting fiscal liabilities on PAM ~~Jaya~~ and the Indonesian government.

Third, structured into the concessions had been provisions for currency hedging in order to indemnify foreign operators from currency risks due to exchange rate fluctuations. Further, the contracts also stipulated provisions for interest rate variations, effectively insulating the operators against potential increases in the cost of capital in the case of capital raising for infrastructure provision. In essence, currency and interest rate risks would be borne by the government; that is, all external shocks would be compensated for by the government, in the process devolving substantial liability to the Indonesian state that would escalate enormously during the subsequent Asian Financial crisis.

Fourth, on top of the water charge was a "management know-how" fee that was to be paid annually to the parent companies of the concessionaires. This was meant to offset the consulting and advising costs of parent and local partners in the management of the concessions.

Fifth, and perhaps most importantly, was the regulatory architecture built into the concessions. The implicit regulatory model adopted was the French one in which the contract itself was assumed to be sufficient to guide the conduct of business – and that the government and private operators could rely on the legal system to adjudicate disputation. There was no independent regulator that would be able to balance interests, no non-legal mechanism for dispute resolution and no regulatory mechanism or IRA to govern rate rebasing and tariff adjustment.

From a regulatory perspective, where effective regulation is meant to balance the interests of stakeholders (private operators, consumers and government) equally, these contracts displayed a biased division of the risks, revenues and profits. Clearly, financial risks in the sector were "socialised" and to be disproportionately borne by PAM JAYA and the Indonesian government, while the economic benefits were to be reaped by the private operators. As many observed at the time of the announcement of the contracts, the operators of the concessions had negotiated a winning deal; guaranteeing returns and offloading revenue, currency and interest rate risks. Regardless of what happened in the sector the private operators were guaranteed a 22 per cent IRR.

More broadly, however, the concessions also represented a general failure for the sector. For example, the concessions created a great deal of uncertainty (which the contracts failed to address), including the employment, employment security and rate of pay for staff of PAM JAYA who, in effect, had become reliant on the concessionaires. These staff formed 90 per cent of the total workforce and yet were not certain who they actually worked for, the terms of their employment, the prospects for salary progression and renegotiation, or career progression.

All these contractual defects were to be exposed in the tumultuous first three years of the operation of the concessions. Indeed, a mere month after the contracts were signed, the Asian financial crisis began to hit Southeast Asia, first in Thailand which witnessed massive runs on the Thai baht and then Indonesia, with equally devastating runs on the Indonesian rupiah. For the Indonesian economy, the external shocks were devastating, causing huge increases in the price of food, medicines and other imported commodities as the rupiah fell in value. The extent of the currency depreciation was unparalleled, with the rupiah to U.S. dollar falling from 2,300 in July 1997 to more than 14,000 in February 1998. The ensuing economic dislocation created widespread protests as tens of millions of people were thrown into abject poverty and unable to afford basic necessities, including food as rice prices rose dramatically. With mass political unrest, President Suharto was forced to step down in May 1998.

Against this backdrop, the impact on the recently privatised water concessions was equally devastating, albeit not for the operators who enjoyed contractual indemnity against currency and interest rate risks. Thus, while the water charge levied by the private operators (and payable in US dollars) remained in place, the revenue to the government (levied in rupiah) fell correspondingly (Bakker 2006), escalating at an alarming rate the financial liability of the Indonesian government. As these liabilities were widely reported to a now mobilised civil society a popular backlash erupted against the water privatisation projects. Indeed, so violent were these protests that the foreign operators were forced to flee Jakarta, leaving the water utilities unattended and PAM JAYA to run the sector (Bakker 2006). Jakarta's water supplies were subsequently disrupted as ~~Pam Jaya~~ workers went on strike and walked out in protest against foreign ownership and the terms of the concessions that had been granted. More detrimental to the sector, however, was the intervention by the Indonesian government, who in an attempt to contain political unrest and anti-government sentiment ordered PAM JAYA not to increase water tariffs for the first three years of the concessions. For PAM JAYA, however, this decision was a costly one, squeezing revenues levied in rupiah while still obliged to service the water charge payable in US dollars. At the same time, PAM JAYA's operating costs escalated out of control amid a national annual inflation rate that ran at 120 per cent.

PAM JAYA's financial situation was an unsustainable one, finally forcing it to break with government policy and increase water tariffs three times (1 April 2001 by 35%, 1 April 2003 by 40% and 1 January 2004 by 30%). News reports at the time showed the public unrest and fears over the drinking water supply. PAM JAYA officials feared that the Jakarta water network might be poisoned because of protests at the water tariff increases. Others even predicted a cholera outbreak (Harsono 2005).

As the crisis subsided, the foreign operators returned. By that time, however, the contracts had been cancelled after demands by local opposition groups to revoke the concessions. The operators responded by calling on their respective governments to put pressure on the Indonesian government and pursue international legal means to recover losses and damages. Under the threat of lawsuits from large multinational corporations, the contracts were subsequently revived, despite popular opposition. The Suharto-linked Indonesian partners, however, were bought out and the names of the companies changed from PT Kekar Thames Airindo (KTA) to PT Thames PAM JAYA (TPJ), and from PT Garuda Dipta Semesta (GDS) to PT PAM Lyonnaise Jaya (PALYJA).

Renegotiated contracts

On 22 October 2001, a new contract was signed between PAM JAYA and the private operators. Both Thames and Suez established new companies: PT Thames PAM JAYA and PT PAM Lyonnaise Jaya~~,~~ were 95 per cent owned by their parent companies in London and Paris, with the shares held by the subcontractors of these international companies. Under the new contract, the multinational companies agreed to give PAM JAYA joint control of the escrow bank account. At the same time, the five service standards and five technical targets monitored by the contract were reset. Notably, under the new contract, targets for coverage and leakage reduction were relaxed to levels so low they were even below those achieved by the local water utility pre-privatisation.

The new contract did, however, provide for a regulatory body, the Jakarta Water Supply Regulator Body (JWSRB). Its terms of reference were "to protect the interest of the consumers and also the interest of the Parties in the Restated Cooperation Agreement (RCA) between PAM JAYA and the two concessionaires" (PAM JAYA and PALYJA 2001: 1; PAM JAYA and TPJ 2001: 1). In practical terms, the main roles of JWSRB were to review tariffs and make proposals to the Governor, to monitor the performance of the companies in terms of service and technical standards, and to meditate disputes between the operators, customers and the government. After its first three-year term, the government strengthened the independence of the regulatory body by specifying that the chairman and members of the Board must be independent from the government and publicly recruited.

An important duty of the JWSRB, as in most regulatory bodies, was to resolve conflicts and balance the interests of stakeholders. Most immediately, JWSRB needed to consider the issue of regular rate rebasing, particularly in light of inflationary pressures. All of this, of course, should have been relatively straightforward since such increases were to be regular, automatic and already set out both in the original contract and the RCA. But the first rate rebasing exercise in November 2003 demonstrated how intractable tariff adjustment had become, and how little real power the regulatory body held.

In preparation for the tariff rebasing exercise, ministry officials set up an Independent Combined Expert (ICE) team, including the JWSRB. In mid-February 2004, the ICE presented its results, setting out the increases expected. Under its terms of reference, the JWSRB could recommend a certain level of tariff but had no power to enforce it; the Governor of Indonesia would still need to give final approval for the increase (Iwanami and Nickson 2008). Not surprisingly, the Jakarta governor declined to implement the increases given their politically sensitive nature and the popular backlash that would result. As a result, the Jakarta government then consulted with the Ministry of Public Works and a joint team was formed to try and forge an agreement for new water charges. Again, this attempt ended in failure. Finally, both parties came to JWSRB and requested mediation. In December 2004, PAM JAYA and PALYJA reached an agreement for a new rebased water charge. TPJ, however, refused to sign on. Not until the end of November 2005, more than three years after the 2002 deadline, was an agreement finally struck. Indeed, it took a High Executive Meeting of the Jakarta Provincial Government chaired by the Governor himself, before the first implementation of a supposedly *automatic* tariff adjustment could proceed.

Market-building in the Indonesian water sector: contractual and regulatory failures

The difficulty of reaching a negotiated agreement for tariff rebasing demonstrates the weakness of both *regulation by contract* and also of the ineffective nature of the regulator once established. In part this was inevitable, since the design of the contract created asymmetrical interests that essentially condemned the sector to gridlock. Indeed, such was the severity of the gridlock and the delay in tariff rebasing that the resulting financial disparity between tariff revenues and the water charge payable to the concessionaires had reached USD$ 100 million by 2005. As an example of market-building in a network industry, the Jakarta water sector demonstrates the considerable obstacles to successful marketisation and, more importantly, the institutional dilemmas in harnessing the rewards that supposedly stem from market-driven efficiencies. While privatisation and the contractual specification of performance and technical standards was popularly held to be a tangible means of improving water sector performance by replacing what, historically, had been a system of patronage prone to poor levels of probity, in reality it proved much more difficult to achieve. Indeed, each of the three elements privatisation promised to deliver (capturing private sector efficiencies, fiscal prudence and credible commitments) failed to materialise. Realising a regulatory state and the associated institutional, environmental and procedural norms necessary to sustain it proved overly onerous in a political context where regulation and technocratic practices were mostly absent. Each of these failed elements necessary to the realisation of a regulatory state can be briefly examined.

1. Capturing private sector efficiencies.

As originally designed, the concession contracts were to capture private sector efficiencies in two key ways – price and competition. The first was to have been captured through the process of selecting the operator, and through the use of key performance indicators and competitive benchmarking. In practice, however, both concessions failed to achieve any efficiency gains. Indeed, what was notable in the case of Jakarta is the way in which such efficiencies were jettisoned. First, for example, the selection process, one of negotiation rather than open tender, was a key factor in eroding potential efficiency gains. The "birth defects" showed that even as privatisation sought to dispel personal ties and political influence in public service provision, these very elements became embedded in the market-building processes.

Equally, the attempt to instil in the sector competitive processes and a series of technical and customer service delivery benchmarks to increase sector performance also fell short. Both operators failed to live up to the contractually stipulated performance indicators – with relative impunity. Much of this stemmed from the lopsided nature of the contracts, where the government had little leverage or recourse in the case of poor performance standards. The financial implications to the operators who failed to attain the performance benchmarks as set out in the contract, for example, were financially insignificant, making it more cost-effective to pay the penalty rather than meet the performance benchmarks.

2. Fiscal prudence.

Privatisation was also championed on the basis that it offered fiscal prudence, better management of financial resources and the delivery of public goods in ways that were cost-effective compared with those delivered through traditional state bureaucracies. Fiscal prudence, however, operates when the contractor assumes financial liability for service delivery relative to an income tied to tariff rates. But under the terms of Jakarta's water concessions, fiscal liabilities resided predominantly with the government and PAM JAYA, reducing the incentives for the operators to pass on efficiency gains or even to strive to achieve efficiency gains, indeed creating perverse incentives for the operators in ways that were not aligned with productivity enhancement or efficiency (Laurie and Marvin 1999; Finger and Allouche 2002; Johnstone and Wood 2003; Swyngedouw 2005).

3. Credible commitment.

Regulation and regulatory states operate on the basis of the credibility of commitments made by the government to private sector participants. Without governmental credibility in terms of adhering to a set of rules and procedures that govern the sector, private sector actors will not invest in a sector if they judge that the rules of the game will change and thus impact the security of the investment. Regulation, particularly the emplacement of an IRA, is thus viewed as necessary in order to normalise practices that support commercial activity through the assurance of impartial governance of the sector. In the case of the water sector in Jakarta, however, regulation came after the fact and then only partially. Rather, regulation by contract was adopted as the means to indemnify investors against government opportunism and political risk. For investors, the sanctity of the contract was assumed to be sufficient to protect interests, and the legal system sufficiently impartial to ensure a fair resolution to disputes. In practice, however, the utilisation of legal instruments is always a cumbersome, costly and time-consuming affair. Perhaps because of this, there was no attempt by either side (the private operators or the government) to use the courts in the enforcement, or the mediation, of the contractual terms. Rather, this process was devolved to a set of negotiations that were ad hoc, effectively politicising issues around tariff rebasing. When the legal system was invoked, ironically this was not to seek redress over contractual issues but to prosecute the concessionaires on charges of corruption. Instead, the process of contract enforcement thus proceeded in fits and starts through negotiation and political bargaining.

More obviously, the termination of the concessions and their subsequent reinstatement after renegotiation also highlighted the fickle nature of Indonesia's political system and decision making, not least the highly volatile, corrupt and unstable environment for those contemplating sinking investments into the country. While the contractual terms of the water concessions can certainly be questioned in terms of their fairness and the allocation of risks, costs and profits, at the end of the day capricious government decision making, policy reversal and contract repudiation also represented ~~sizable~~ risks for investors which, for over a decade, condemned Indonesia to net capital foreign outflows as investors withdrew money and fled to safer jurisdictions.

Conclusion

Privatisation has clearly not brought Jakarta any closer to the promises of higher efficiency, increased investments or better services in the water sector. For consumers, it has been a clear failure. Complaints about the quality, quantity and regularity of the water supply persist (Platts' Global Water Report 2002). As the Jakarta Post observed, "despite the entrance of two foreign companies [into the sector], people in Jakarta still complain about the quality of the water they produce as well as disruption to water supply…The two companies have…failed to expand their networks arguing that the city administration had increased water rates only a fraction of the amount they had requested" (Hall 2002: 7).

Consumer groups, meanwhile, have continued to protest the price rises and the lack of service to the poor. Indeed, for the majority of Jakarta's poor, water remains an expensive commodity, with most forced to buy drinking water from street vendors while about 70 per cent of the city's poor still lack access to running water.

For the private operators, by contrast, the renegotiated contracts remain in place but the terms of the contracts not necessarily honoured. The promised tariff increases, for example, have not come about, and negotiations are ongoing about the payment of debt that has accumulated through the water charge.

For the government, by contrast, the promise of fiscal prudence has not been realised; if anything fiscal liabilities have grown but absent any net gains in the service quality or network coverage of the sector. Rather than the win-win situation envisioned when the contracts were first issued, for the government and consumers privatisation efforts have resulted in net losses.

Such outcomes explain why there are persistent calls for the contracts to be terminated. Such pressures, however, perhaps must be resisted, not least because the public operators, after two decades of relative inaction, may not have the wherewithal to operate the system. More obviously, contract repudiation at this late stage would expose the Indonesian government to liabilities and reputational issues that would have a negative impact on the economy – not least in terms of perceptions among the international investment community. For the foreseeable future, the sector is thus condemned to limp along much as it has done for the last decade.

As an effort in market-building there are few commentators that would count the case of the Indonesian water sector as a successful story. Rather, its legacy stands as a testimony to the inherent dangers of marketising sectors absent quality institutional and regulatory design, transparent tendering processes, and due process in the allocation of sector risks, costs and profits.