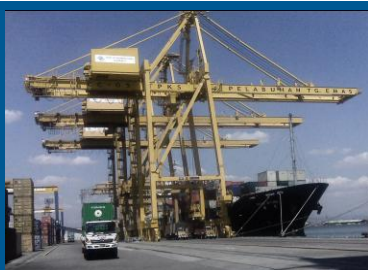




Australia Indonesia Partnership
Kemitraan Australia Indonesia



PUBLIC SERVICE OBLIGATION AND PIONEER SERVICE POLICY IN THE TRANSPORT SECTOR



**INDONESIA
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INDONESIA INFRASTRUCTURE INITIATIVE

July 2010

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Any errors of fact or interpretation are solely those of the authors.

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Jakarta, July 2010

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ACRONYMS

ADB	Asian Development Bank
AusAID	Australian Agency for International Development
Bappenas	The National Development Planning Board
CMEA	Coordinating Ministry of Economic Affairs
EIRR	Economic Internal Rate of Return
FIRR	Financial Internal Rate of Return
GOI	Government of Indonesia
IndII	Indonesia Infrastructure Initiative
IMO	Infrastructure Maintenance and Operation
MOF	Ministry of Finance
MOT	Ministry of Transportation
MNA	Merpati Nusantara Airline
MSOE	Ministry of State Owned Enterprises
NSC	Non-Commercial Services
OECD	Organisation for Economic Cooperation and Development
OBC	Outline Business Case
PELNI	National Shipping Line
PBC	Performance Based Contract
PSO	Public Service Obligation
PS	Pioneer Service
PT KAI	Indonesia National Railway
TAC	Track Access Charge

CHAPTER 1: OVERVIEW REPORT: PUBLIC SERVICE OBLIGATIONS AND PIONEER SERVICES POLICY

1.1 INTRODUCTION

This chapter sets out the background for the Public Service Organisation (PSO)/Pioneer Service (PS) assignment and the process that was adopted to develop the PSO/PS Policy Document and the Implementation Guidelines.

The Government of Indonesia (GOI), through Presidential Instruction (Inpres no. 5/2008), requires Bappenas to develop a Policy for PSO (in this context the term includes PS). The following table is a summary of the program, required action, the output and the target of the Policy work:

	Program	Action	Output	Target	Responsible Agency
Improve government policy on PSO	Develop PSO policy	Prepare regulation on PSO in infrastructure	Regulation on PSO	Effectiveness and efficiency of PSO in order to provide better service to the community	Bappenas

In addition to Inpres no. 5/2008, there are three other policy issues that relate to developing a clear PSO and PS Policy:

- Target of transportation development 2010 – 2014 in National Medium Term Development Plan (RPJMN) 2010 – 2014
- Infrastructure Reform Sector Development Program (IRSDP) Policy Matrix
- Infrastructure Development Policy Loan (IDPL) Policy Matrix

Accordingly, Bappenas requested IndII to undertake a Policy Study of PSO and PS in Indonesia. The IndII consultant team commenced the assignment in September 2009.

1.2 PROJECT PROCESS

The project process has been focused on obtaining a ‘buy-in’ to the Policy and the Guidelines by Bappenas as the project sponsor. The other major agencies that are needed for the Policy to be adopted and successful are the Ministry of Finance (MoF) and the Ministry of Transport (MoT) – their buy-in has been sought progressively. Strong support is also needed from the Coordinating Ministry of Economic Affairs (CMEA).

1.2.1 Project Steps

The steps undertaken by the consultants in the Policy and Guideline development process are set out in the following table:

Timing	Step/Activity	Output
September/October 2009	Research international best practices and current PSO and PS arrangements in the transport sector.	Research Paper on International practice. Discussion with Bappenas on International Practices and possible policy principles to be adopted for Indonesia.
4 November 2009	First Workshop on PSO: initial findings of current PSO and PS arrangements in the transport sector and a potential PSO and PS development process.	Initial Policy position put to Bappenas, MoF, MoT and PT KAI and PT ASDP, PT Merpati. Broad views of the transport sector, from MoT and from the service deliverers.
November 2009 to December 2009	Prepare a Draft Policy and Guidelines for PSO and PS in the transport sector, including consultation with various stakeholders of PSO and PS (CMEA, MoT, MoF, Ministry of State Own Enterprises [MSOE])	Individual comments and suggestions for the PSO/PS Policy. Additional knowledge on the regulatory structure for PSOs/PS and the potential impediments to major policy platforms like multi-years contracts.
15 December 2009	Second Workshop: Bappenas internal discussion on Draft Policy and Guidelines for PSO and PS in transport sector.	Basic agreement by Bappenas to the Draft Policy and the “Key Process” for managing PSO/PS proposals. Agreement to take the Draft Policy to a major workshop involving Bappenas, MoT (all sectors), MoF, CMEA and MSOE.
January 2010	Internal discussions with Bappenas staff on the PSO/PS Policy. Firming up the four policy pillars for the Policy.	Draft Policy Document prepared for presentation to a major workshop held in Bandung.
January 2010 to February 2010	Prepare the activity design for a potential pilot project in eastern Indonesia, including a field visit to Jayapura.	Strong interest by Jayapura in developing a pilot project. The Provincial Secretary, Bappeda, Dinas Perhubungan, and the Port Regulator were informed of the proposed pilot project and the basic requirements for the pilot to proceed (including safety controls being in place and inter-agency cooperation).
February to May	Finalising the PSO and PS Policy, Guidelines and Business Case guidelines and tools including the economic analysis and financial analysis tools.	Completion of the economic analysis tool and the financial analysis tool. Draft Policy presented at the Echelon 1 Seminar on 5 May 2010

Timing	Step/Activity	Output
3 – 4 March 2010	Workshop (at Bandung) on Improvement of Policy and Guidelines for PSO and PS in the Transport Sector.	Approximately 70 attendees to discuss the Policy and Guidelines. A workshop agreed document on the PSO/PS policy pillars, the key process and the implementation principles.

Throughout the project, meetings were held with Bappenas staff on project progress and the processes to adopt to gain buy-in from Bappenas and other GOI departments and agencies. The meetings were also used as a means of transferring to the Bappenas staff, the technical approach to developing the PSO and PS Policy and Guidelines. The meetings were held every three to four weeks.

Meetings were held with individual senior officials at CMEA, MSOE and within the MoT on their attitude towards the Draft Policy as well as defining the barriers or impediments to the Policy implementation.

1.2.2 Policy Meeting - 5 May 2010: Improvements in the PSO and PS Policy for the Transport Sector

A policy meeting, sponsored by Bappenas, was held on 5 May 2010. Its purpose was to agree on the PSO and PS Policy Framework prepared by Bappenas, including Multi-years contracts and the introduction of a business case for PSO/PS assessment and to agree on the next steps to implement the Policy Framework (Stage 2 of the Project). The meeting was critical to obtain GOI acceptance of the draft PSO/PS Policy Framework.

The invitees to the meeting were Echelon 1 civil servants, on the basis that they would be empowered to make decisions on the Policy.

The agenda for the Policy meeting was as follows:

- An explanation of the IndII PSO and PS Policy Project instituted by Bappenas.
- A presentation by the IndII consultants of the proposed PSO and PS Policy Framework in the transport sector.
- Outline of a potential stage 2 of the project that involved Pilot Projects to test the policy and additional guidelines for other transport sub-sectors.
- Open forum discussion on the Policy and implementation issues including impediments.

At that point all indications from Bappenas were positive and supportive of the proposed policy, including the proposal for a Pilot Project to test the policy framework.

The meeting was generally attended by Echelon 1 civil servants as substitutes for the invitees, including a substitute for the Directorate General Sea Transport.

The discussion at the meeting centered on the following issues:

- Introducing some of the key concepts of the Policy was difficult – especially multi-years contracts and performance based contracts (PBCs);

- the implementation timeframe may need to be longer than five years (as recommended in the Policy framework);
- the need to be clear on what rules/policy would apply to the Pilot Project;
- many of the concepts in the policy framework could be very useful, but difficult to implement or needed to be implemented prior to the Policy being agreed;
- it may be best to implement some of the tools, like the Business Case and the multi-years contracts and PBCs ahead of a Policy to test them first.

On the basis of the discussion, the Implementation Framework contained in the PSO Policy Document has been adjusted to accommodate a partial implementation without a Policy being in place.

It is open to the GOI to choose how to use the document in the revision of the PSO/PS arrangements in Indonesia.

The Executive Summary for the Project provides a good synopsis of the Policy and the Guidelines and the draft implementation plan that has been developed through the consultative approach conducted by the Project Team.

CHAPTER 2: EXECUTIVE SUMMARY

2.1 INTRODUCTION

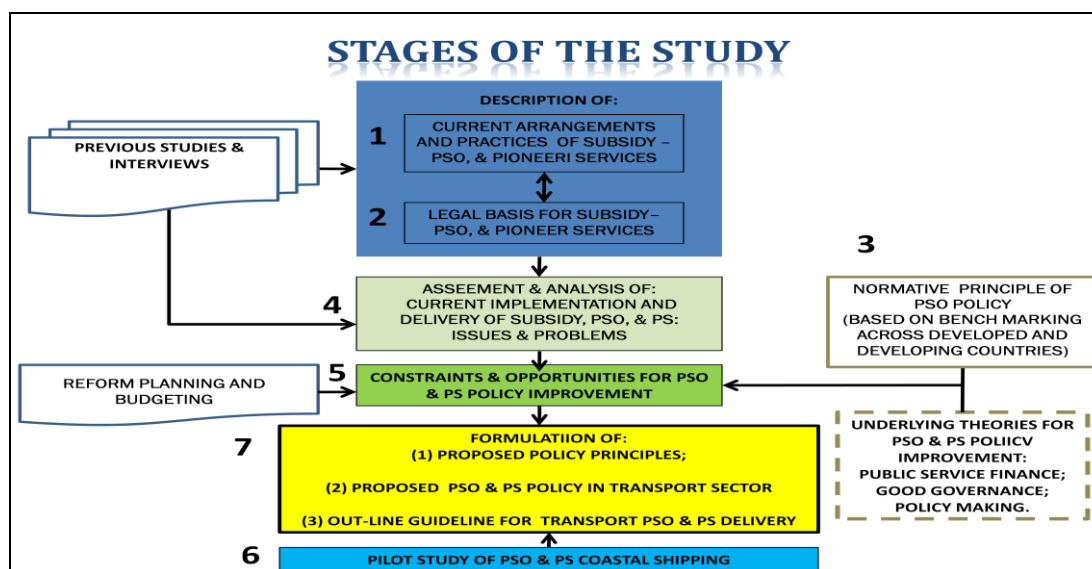
2.1.1 Background

The GOI spends approximately 15 percent of its budget on subsidies of various kinds. Those subsidies relate to the provision of products such as fertilisers, petrol, electricity, generic-medicine and the provision of services, such as cheap transport at tariffs that are lower than commercially viable tariffs. The GOI has decided to target PSOs and PS which receive subsidies from the government of the tariff and the actual service provision, in order to make services readily available to the poor or to promote regional development.

IndII has been asked by Bappenas to undertake a Policy Study of PSOs and PSs in the transport sector in the context of creating better targets and a better management system for their implementation. The political environment in Indonesia is such that PSOs and PS are now receiving attention for the amount spent on them as well as the targets for them. This attention is in the context of budget constraints from the Government, but also in the context of allocating the funds (spent on these “subsidies”) to better avenues such as on infrastructure investment.

The study has produced Policy and Guidelines for PSOs and PSs in the transport sector. The guidelines comprise of: (1) the transport sector guidelines; (2) key processes; (3) economic business case; and (4) financial business case. In addition, four working papers have been completed to include assessment and analysis of current PSOs and PS practices in Indonesia and their legal basis, and reports on Papua and North Sulawesi visits. The stages of the study are depicted in diagram 1.

Diagram 1: Stage of the Study



2.1.2 Financing the Provision of Infrastructure Services

Funding sources for infrastructure services, such as public transport, can be categorised into: (1) revenue generated from payment by users; (2) taxes; or, (3) some combination of the two. Indonesia has long been committed to the “user charges principle”; however, the Constitution obliges the

Government to ensure that all Indonesians, including those with low incomes and/or living in remote areas, have access to essential services. The Indonesian Medium Term National Development Plan 2010-14 for the transport sector emphasises the target “access for all”. More specifically, the plan calls for: (1) development of rural and urban transport systems in remote and underdeveloped regions; (2) improvement of PS for underdeveloped regions in remote as well as border areas; (3) improvement of public transport services for low income people through the PSO scheme.

The above targets will require decisions to be taken with regard to what services are essential, and how best to make them affordable to those who would be otherwise unable to pay the cost-reflective tariffs. Affordability can be increased either by raising purchasing power or by reducing tariffs; this report addresses actions taken to reduce tariffs.

Tariff reduction can be accomplished by providing either direct or indirect subsidies from government budgets, or by requiring cross-subsidies among service users. The options for doing so depend to some extent on whether services are delivered by government agencies, public enterprises, or private entities.

Subsidies for services provided directly by government agencies are often ‘hidden’ in the sense that they are not explicitly recorded as subsidies in budget documents. The situation is different for State-Owned Enterprises (SOEs), which are subject to the same accounting and reporting requirements as private limited liability companies. According to the current practices in Indonesia, the three main mechanisms for channelling subsidies to SOEs are:

- compensation for explicit PSO for the full associated costs, including an appropriate profit margin;
- indirect input operating subsidies; and,
- equity injections.

The GOI can also accept a low or negative internal rate of return (IRR) on invested capital, and it can also require SOEs to cross-subsidise between customer groups.

The options are rather different when infrastructure services are provided by private operators, whose interest is profit rather than social outcomes. There are many possible models for structuring subsidies so as to transform a service that is otherwise unattractive to private investors, into one that offers a reasonable return. The term ‘negative concession’ is often used to describe where services (e.g., pioneer shipping) are tendered for delivery by a private operator on the basis of minimum subsidy requirement.

Based on the above, two types of public services are recognised: (1) full cost recovery public services, and (2) subsidised public services. The delivery of the first type of public service can be offered to private providers. The second type, which is provided to people in lower income groups and/or those living in remote areas, can be delivered by either the SOEs or private providers.

In the case of subsidised public services, the tariff or fee to be paid by users is determined by the government, which then compensates the service provider for the difference between the income from providing the service and the cost/appropriate profit due to the operator for providing the service. Clearly, the process of transferring the subsidy should be transparent and accountable.

This second type of public service, therefore, is similar to the normative definition of PSO.

A simple assessment approach based on composite variables of economic benefit (measured in Economic Internal Rate of Return [EIRR]) and financial feasibility (FIRR) is employed for defining PSOs

and PSs. Public services with positive EIRR and positive FIRR are categorised as Commercial Services and will be offered to private providers. Services with positive EIRR but negative FIRR will be funded through the government subsidy programme. Services with both negative FIRR and EIRR ideally would not be delivered through the government; however, for social or political reasons, these services may be provided with full or partial subsidies.

2.2 CURRENT PRACTICES FOR PUBLIC SERVICE OBLIGATION (PSO) AND PIONEER SERVICE (PS) IN INDONESIA

The next section discusses various forms of PSO/PS in the Indonesian transport sector. In this regard, PSO/PS includes: (1) PSO under the SOE Law no. 19/2003 in railway and shipping; (2) PS in the sub-sectors of air, land and sea transport; and (3) other subsidised services, e.g., bus lines for the purpose of encouraging the use of public transport in large urban areas (see diagram 1). The discussion focuses on the PSO and PS in Indonesia, specifically on shipping services (see diagram 2), which is chosen as the initial step for the study, because it encompasses the uniqueness of Indonesian transport services. The elaboration of sea transport PSO and PS includes:

- definition and objectives of the service delivery;
- target groups/areas;
- process/mechanism in the program formulation and delivery of services (see diagrams 3 and 4);
- stakeholders responsible for program formulation and service delivery; and,
- cost structure and subsidies provided by the government (see diagrams 5, 6 and 7).

Diagram 2: Current Practice on Public Services in Indonesia

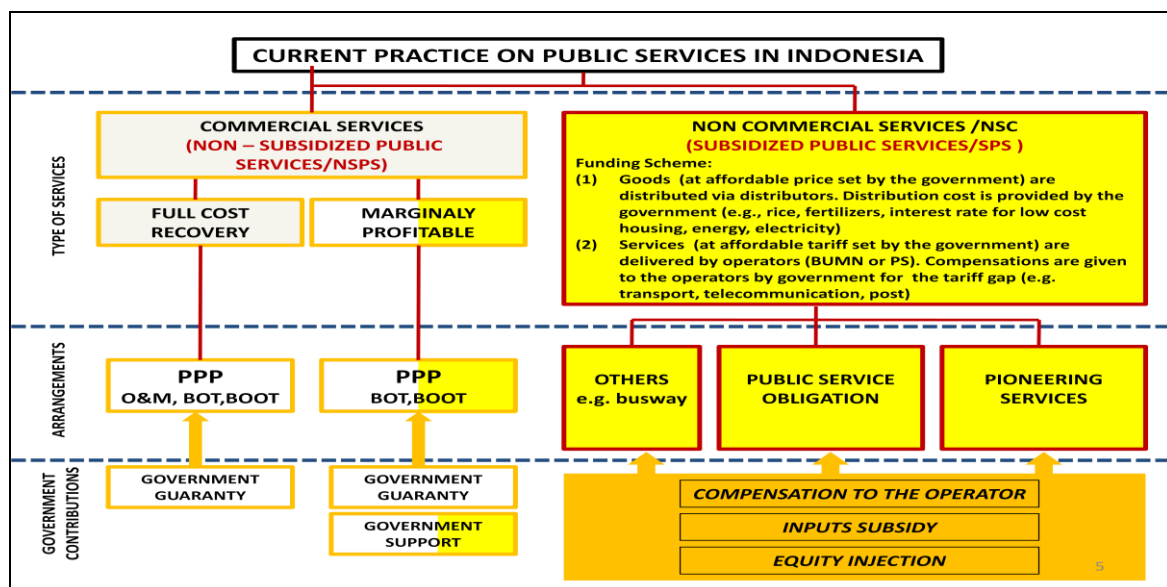


Diagram 3: Current Structure of Non-Commercial Services (NCS) in Transport Sector Indonesia

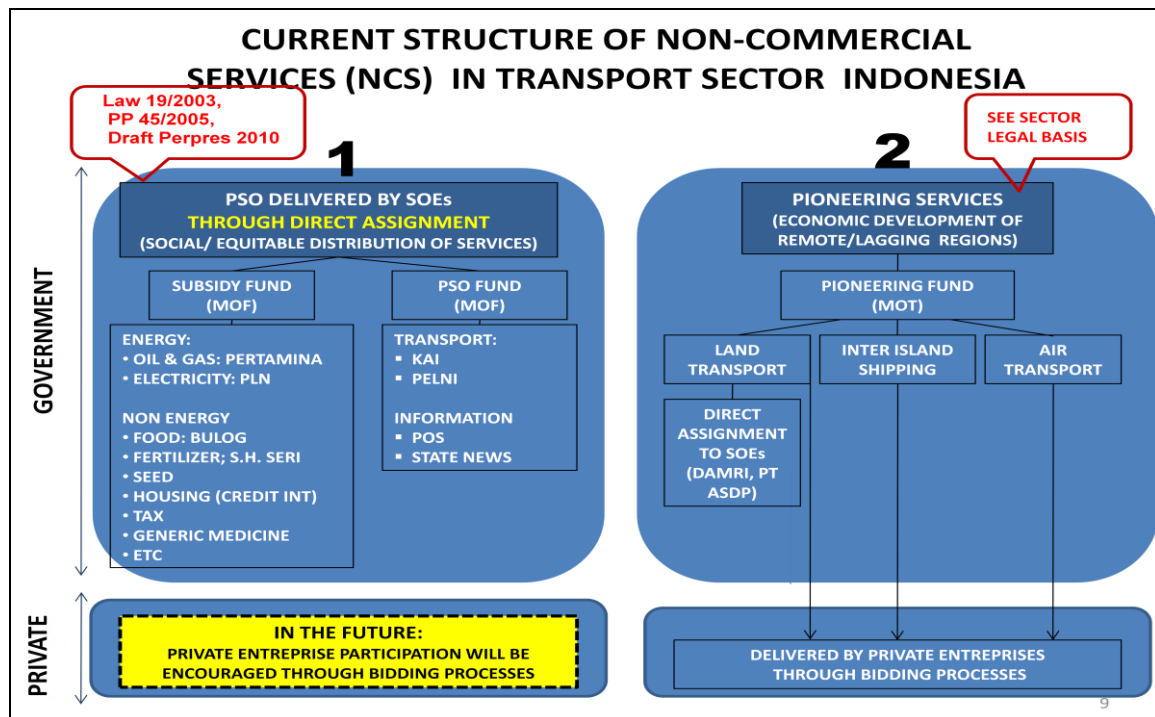


Diagram 4: Current Process for PSO Delivered by SOES

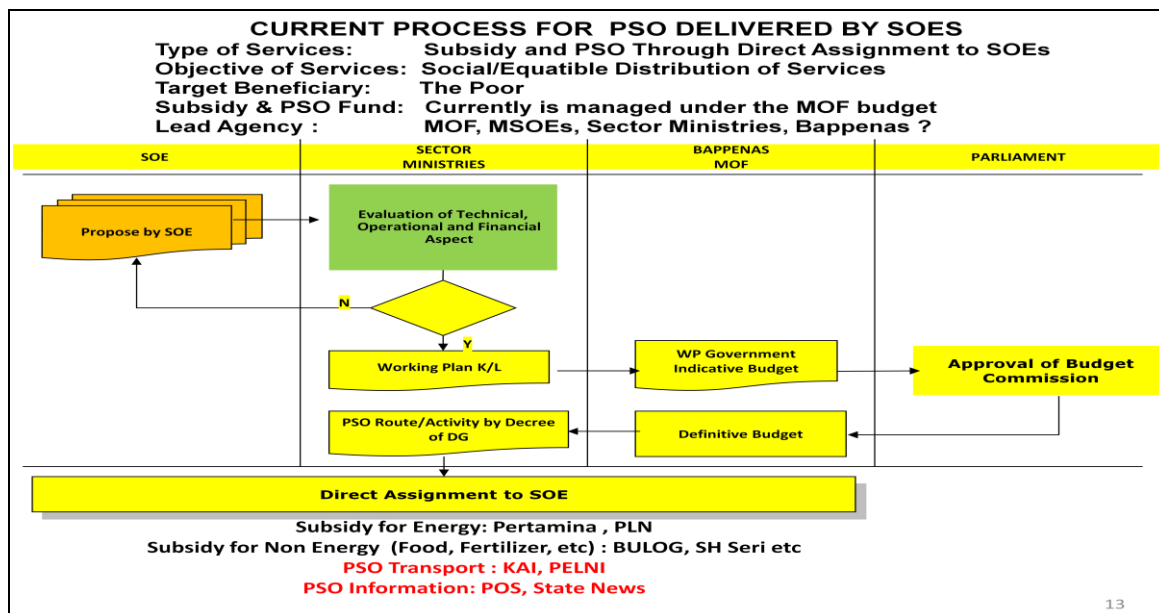


Diagram 5: Current Process for Pioneer Services

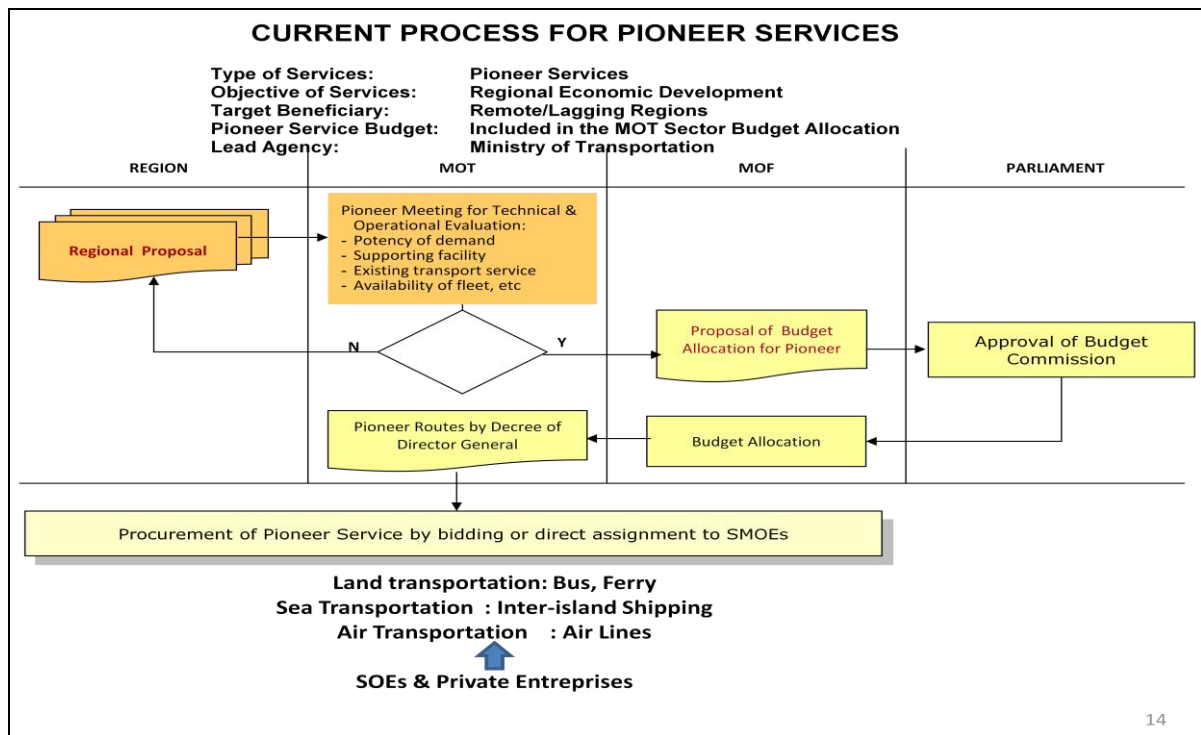


Diagram 6: Cost Structure for PSO Sea Transportation 2009

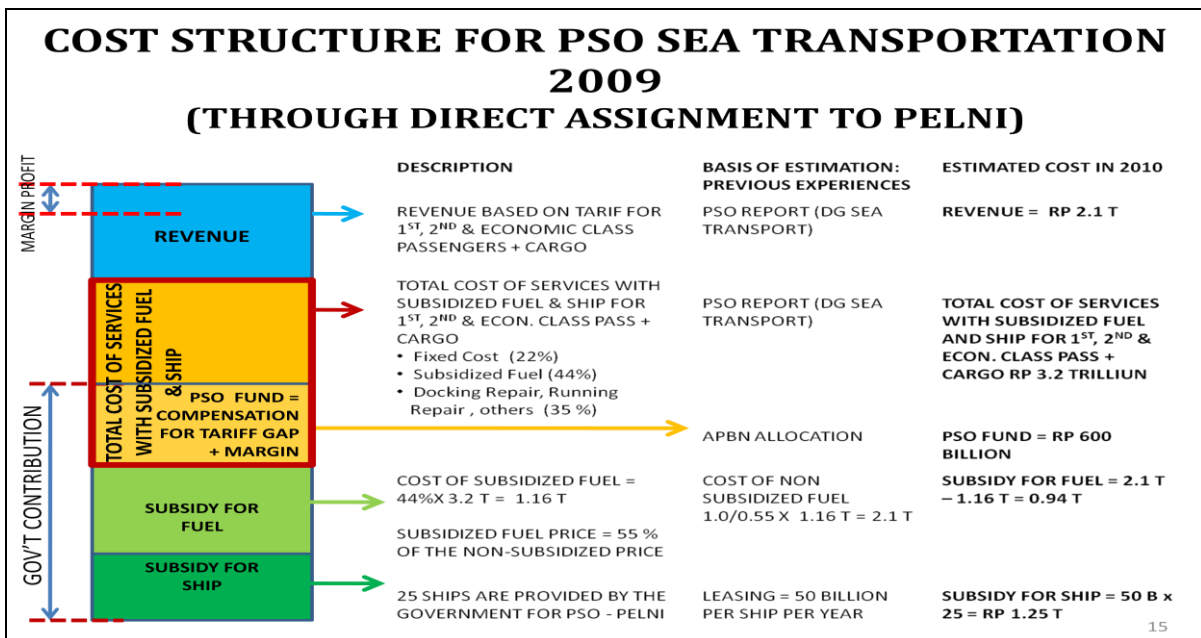
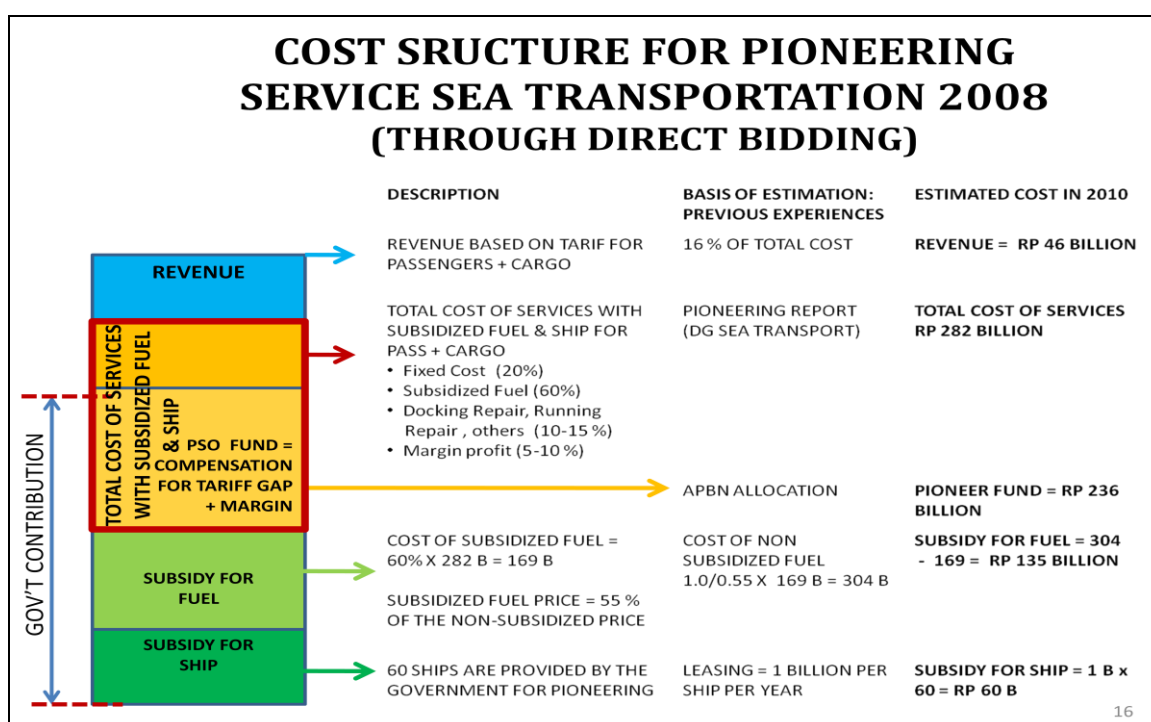


Diagram 7: Cost Structure for Pioneering Service Sea Transportation 2008



The brief definition of PSO for inter- and intra-provincial shipping in Indonesia (under Law no. 19/2003) comprises the following: (1) economy class services provided for low income groups; (2) tariffs/fees are determined by the government; (3) the service is delivered by the SOE (PT PELNI), through direct assignment by the MOT in coordination with the MOF and the MSOE; (4) three main mechanisms for channelling subsidies to PELNI are available, i.e., compensation for the full associated costs, including an appropriate profit margin; indirect input operating subsidies; and equity injections.

At present, PSO in the shipping sub-sector serves 23 inter- and intra-provincial routes utilising 24 ships. In this regard, the ships are provided by the government as equity injections to PT PELNI. The routes range from 2,100 miles to 7,050 miles with an average distance of 3,500 miles per route. The 24 ships in PELNI's fleet include those with capacity to carry 500 passengers (3 ships), 1,000 passengers (7 ships), 2,000 passengers (13 ships), and 3,000 passengers (1 ship). For the 14 ships in the 2,000 to 3,000 passenger capacity range, economy-class passengers represent approximately 50-70 percent of total capacity, while for the smaller ships, economy-class passengers represent approximately 90 percent of total capacity. Based on field interviews, the average load factor ranges from 50 to 60 percent of capacity.

The primary objectives of PS are to promote the development of economically lagging and geographically remote regions, and to enhance national unity and stability. PS are delivered by private providers based on annual contract agreements through bidding processes. As with the PSOs, the tariffs are set by the government, which compensates the provider for the difference between the tariff income and the cost of operations and maintenance plus the contractually agreed profit margin.

Currently, PS providers operate 56 routes and 30 ports throughout Indonesia; 11 routes are for the western part of the country, while the remainder serve the east. Ship sizes vary from 350 to 750 DWT ("deadweight tonnage" or the maximum weight that a ship can safely carry) which is smaller than the PSO ships. Many of the routes serve intra-provincial shipping, and some connect two or three

provinces. Approximate time per round-trip voyage is 10 to 27 days, and the target frequency is approximately 14 to 36 voyages annually. Field interviews reveal that the average passenger load factor is low; however, due to political considerations, these services are considered necessary.

2.3 ISSUES AND PROBLEMS

Based on the results of this study and others, several issues at the policy and delivery levels are identified.

Issues and problems at the policy level include the following:

- inconsistency and lack of clarity among the terms and definitions employed in the context of subsidy policy, which leads to different interpretations and misunderstandings between relevant parties and decision makers;—this situation is exacerbated by inconsistency and conflicting regulations controlling service delivery;
- unclear or unavailable data regarding market potential and target groups for use by the PSO and PS;
- current public transport policy, especially in the case of PSO, tends to encourage a monopolistic delivery system, leading to inefficient and ineffective public services;
- decision-making processes for subsidies, PSO and PS are not transparent and are often influenced by political considerations. This situation hinders efforts to improve the efficiency and effectiveness of services through a competitive approach;
- inconsistency from government bodies and service providers between sub-sectors, leading to disharmony in service delivery mechanisms; and
- on the one hand the need for subsidies for PSO and PS tends to increase in line with demand and the need for better quality standards; on the other hand, the budget for infrastructure provision is limited.

Salient problems encountered in the shipping PSO and PS delivery include:

- unclear service targets and schedules;
- unclear indicators for measuring service performance, limiting useful feedback and communication;
- the annual contract arrangement for service delivery has resulted in a lack of motivation on the part of the service providers to deliver better services and appropriate maintenance; multi-years contract would minimise this problem but current law does not allow this change;
- different formulae are employed by the contracting agency and the service providers to determine fair compensation;
- unclear distinction of cash-flow between the PSO economy-class and other passenger classes, leading to difficulty in identifying profit or loss in the service revenues;
- payment delays to the service providers; and
- the proportion of fuel cost to total production costs is significant; therefore, the amount of the necessary subsidy is significantly influenced by fluctuations of the world oil prices.

2.4 PROPOSED POLICY FOR PSO AND PS IN THE TRANSPORT SECTOR

2.4.1 Policy Principles

The last section of the study considers the main points that need to be raised and discussed in the effort to create a common understanding and agreement to serve as the basis for PSO/PS policy reforms and guidelines in the transport sector. This basis is required not only for partial changes in the short term, but for the accomplishment of longer term goals, as well.

Five goals of policy improvement are: (1) guaranteeing access for all; (2) enhancing regional connectivity; (3) ensuring transparency, i.e., compliance with good governance principles; (4) consistent rationalisation of the tariff gap for PSO/PS operators; and, (5) fair competition in service delivery, thereby improving efficiency and effectiveness of services.

2.4.2 Policy Elaboration

This study concludes with the following recommendations to be made to the appropriate policy makers:

- Efforts to improve efficiency and effectiveness of public transport services require a policy that promotes fair competition among service providers including the private sectors. In the case of current PSO practice, selection of service providers is based on direct assignment to SOEs. In the future, fair bidding processes to select the service providers, and the principle of Value for Money (VFM) will be applied.
- Both, in the PSO/PS schemes, contractual agreement will be based on agreed service performance. In this regard, contracting agency (MOT) and the Provincial Government will formulate an Outline Business Case (OBC) in which the program digest is described. The OBC will then be offered to the interested private sectors and SOEs. The local governments who better understand demand for market services in their locales will be actively involved in the OBC formulation process.
- A multi-years contract will be employed in a step wise strategy for the purpose of encouraging the private sector to participate in the service provision.
- Given the fact that PSO and PS have similar platforms, harmonisation of both processes and mechanisms to deliver services should be conducted.
- Rationalisation of the gap for compensation given by the government to providers needs to be directly implemented through PBCs.

A set process for the development/review, and delivery, of PSO and PS is also proposed. It defines the starting point and the responsibilities for each step. Coupled with that process, the Policy institutes a Business Case for considering a PSO or a PS. That Business Case has the following outputs:

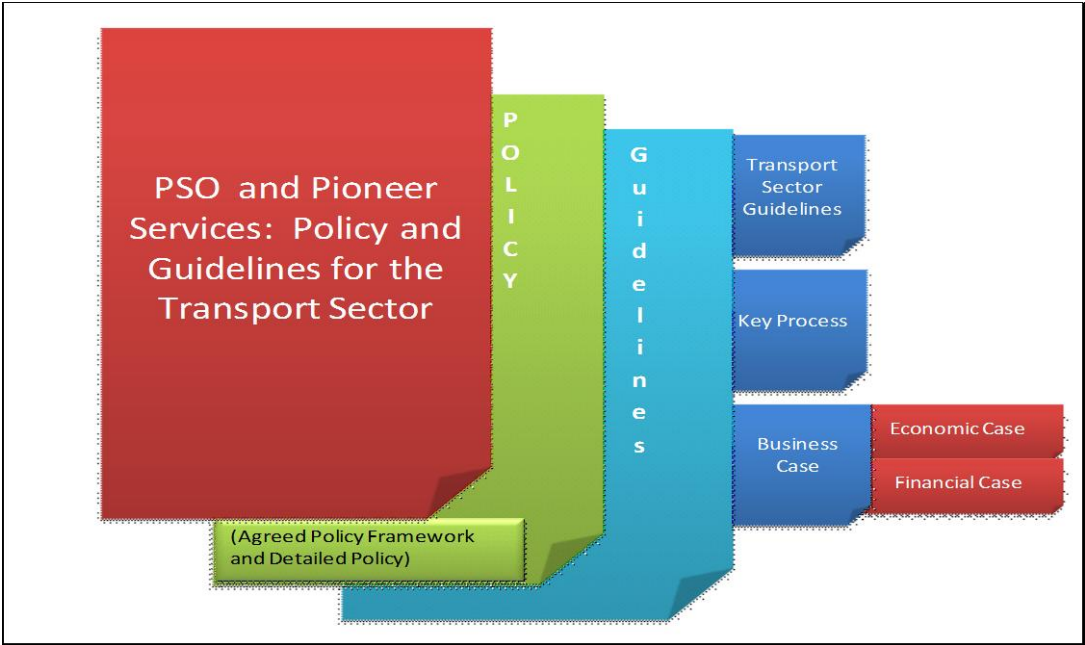
- Whether the proposal meets the policy objectives of “Access for All”;
- whether it meets the policy objective of “Enhancing Regional Connectivity”;
- the estimated “economic benefit to Indonesia” resulting from the PSO or the PS, with the benefits quantified in terms of travel demand, aggregating different benefits and measuring whether this is a positive or negative impact, and the direct impact on poverty; and

- the estimated cost of the PSO or PS and the financial case, including a recommended budget strategy.

The final Policy document and guidelines are presented in the format shown in diagram 8 below, and will include:

- The PSO and PS Policy that is to apply to the transport sector;
- the Implementation and Operational Guidelines that will apply across the transport sector;
- the set process for developing, reviewing and managing PSOs and PSs across the transport sector; and
- the Business Case including the economic and financial analysis tools.

Diagram 8: Outputs of the Study



2.5 IMPLEMENTATION PRINCIPLES AND STRATEGY

The introduction of the PSO and PS Policy requires a staged approach. The Policy can be issued but with a plan for its introduction.

The principles for the Policy implementation that have been agreed are:

- An implementation strategy which will be agreed by Bappenas, MOT, CMEA, and MOF;
- Government will encourage private sector participation in PSO and PS, including multiyears contract as appropriate to sub-sectors;
- Government will implement PSO and PS Policy with more accountability and transparency according to laws and regulations.

The following table describes each of the stages in the implementation plan:

Table 1: Stages of the Implementation Plan

Stage	Work Program
Year 1: Position and Preparation Year	<ul style="list-style-type: none"> • Introduce the institutional approach for the development and review of PSOs and PS, including the approach for reviewing a PS at the Regional Government level. • Undertake market analysis for 20 percent of PS routes. • Undertake the review of the PSO for shipping. • Commence the Business Case Analysis. • Prepare competitive tender documentation for both PSO and PS, including multi-years contracts. • Define the MOT purchased fleet of ships for PSO and PS.
Year 2: Program Commencement Year	<ul style="list-style-type: none"> • Undertake market analysis for next 20 percent of PS routes. • Tender out PSO and PS on an output based and multi-years contracts. • Formula for PSOs and PSs removed from the regulations. • Complete a review of all existing regulations (and other laws) and implement new regulations based on the PSO/PS Policy. • Introduce a funding cap for PSO and PS (with fiscal risk allowance).
Year 3: Program Consolidation Year	<ul style="list-style-type: none"> • Undertake market analysis for the next 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Undertake and complete Tariff Gap Rationalisation strategy.
Year 4: Program Consolidation Year	<ul style="list-style-type: none"> • Undertake market analysis for the next 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Test the Gap Rationalisation approach with the community (socialisation). • Establish the monitoring review framework for Year 5.
Year 5: Program Consolidation and Review Year	<ul style="list-style-type: none"> • Undertake market analysis for the final 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Commence PSO Tariff Gap Rationalisation strategy. • Undertake program review and present findings.

The implementation plan is deliberately flexible. It is sufficiently flexible to introduce the proposed Business Case without the major PSO/PS Policy being in place. It also allows for the systematic review of the PS shipping routes to begin the route rationalisation process and the costs associated with providing those services.

CHAPTER 3: TRANSPORT SECTOR: PUBLIC SERVICE OBLIGATIONS AND PIONEER SERVICES POLICY

3.1 ASSESSMENT OF INDONESIAN PSO POLICY

3.1.1 Scope of the Policy Document

The Terms of Reference (ToR) for the project ask for a PSO Policy to be developed for Indonesia and for an activity to be scoped to test PSOs in coastal shipping services in Eastern Indonesia. The ToR require “developing an effective, transparent and practical policy framework for formulating and implementing non-commercial infrastructure services”. The target standard is ‘international best practice’.

This paper is limited to transport sector infrastructure services at a national level and does not include subsidies/PSOs delivered by local governments.

The sectors that are the subject of this Policy paper are:

- Aviation, including PS;
- Land Transport, including PSO and PS;
- Inter-island shipping, including PSO and PS;
- Rail including PSOs.

The Policy and the Guidelines developed under the ToR for this project will deal with the transport infrastructure sectors and not electricity, water supply (because it is administered by the local government) and telecoms (because it has its own independent PSO fund in operation).

This paper does not deal with oil, fertiliser or rice subsidies. They are separate non-infrastructure issues and require a separate commissioning of the question.

3.1.2 Assessment of Indonesian Policy and Practice

A detailed assessment was undertaken and documented in December 2009 with the Discussion and Draft Policy paper for the provision of non-commercial services in the transport sector (Public Service Obligations). What follows is a synopsis of that assessment.

The development of a policy requires a ‘stake in the ground’ approach. The policy must be grounded in a principle which, in the case of PSOs/PSs in Indonesia, is a constitutional value that supports the notion of PSOs and PS. From that policy principle, a definition of a PSO/PS is needed to scope what the policy will be about.

The Constitution sets the basic policy source for PSOs/PSs¹:

¹ ADB TA 4728-INO: Support for Infrastructure Development: PSO Policy and Roadmap. Final Report February 2008 defines these two sections as the source of PSO policy and process.

- Sections 33(2): Production sectors that are vital to the state and that affect the livelihood of a considerable part of the population are to be controlled by the state.
- Section 34(3): The state has the responsibility to provide proper medical and **public service facilities**.

The policy on PSOs and PSs in Indonesia has many sources – the 30 sets of laws (and another 20 sets of laws that have an indirect impact) set out below are included.

	SEA TRANSPORT		ASDP	LAND TRANSPORT	AVIATION	RAILWAY TRANSPORT	
	PSO	PIONEER	PIONEER	PSO & PIONEERING	PIONEERING	PSO	PIONEER
Cross Sub-Sector Regulations	Law 19/2003 on SoEs	-	-	Law 19/2003 on SoEs	-	Law 19/2003 on SoEs	-
	Law 25/2009 on Public Services						
	Keppres 80/2003 on Government Goods/Services Procurement						
Sub Sector Regulations	Law 17/2008 on Maritime Transportation Gov't Regulation 20/2010 on Water Transportation MoF Regulation 123/2009 on the Procedure of Provision, Disbursement, and Accountability of PSO Fund for Economic Class in Sea Transportation MoT Regulation KM 44/1990 on the Tariff Policy for Passengers and Goods Transportation that has been amended by MoT Regulation KM 8/1995 MoT Regulation KM 57/2006 on the Mechanism for Determining and Formulating Domestic Passenger Sea Transportation Calculation MoT Regulation KM 54/2009 on the Implementation of PSO in Economic Class Sea Transportation in 2009	Law 17/2008 on Maritime Transportation Gov't Regulation 20/2010 on Water Transportation MoT Regulation 33/2001 on the Provision and Management of Sea Transportation MoT Regulation 86/2002 on the Tariff for Passengers and Goods in Air Transportation on Pioneer Services	Law 17/2008 on Maritime Transportation Gov't Regulation 20/2010 on Water Transportation MoT Regulation 33/2001 on Provision of Ferry Transportation MoT Regulation 73/2004 on Provision of Lake and River Transportation (Amended by MoT Regulation 58/2007)	Law 22/2009 on Traffic and Land Transportation Government Regulation 41/1993 on Land Transportation MoT Decree KM 44/1990 on the Tariff Policy for Passengers and Goods Transportation that has been amended by MoT Regulation KM 8/1995 MoT Decree KM 89/2002 on Mechanism of Tariff Determination and Formulation of Basic Cost for Economy Class Intercity Public Bus that has been amended by MoT Regulation KM 52/2006. MoT Regulation KM 60/2007 on the Provision of Subsidy for Public Road Passenger Transport MoT Regulation KM 35/2003 on the Provision of People Transport in the Road through Public Vehicles.	Law 1/2009 on Aviation Government Regulation 40/1995 on Air Transportation that has been amended by Government Regulation 3/2000 MoT Regulation 18/2007 on Tariff of Pioneer Air Transportation that has been amended by MoT Regulation 19/2008 MoT Regulation 25/2008 on the Provision of Air Transportation	Law 23/2007 on Railways Government Regulation 72/2009 on Railways Traffic and Transportation Joint Ministerial Decree MoT, MoF, and Head of Bappenas No. KM 19/1999, No. 83/KMK.03/1999, No. KEP.024/K/03/1999 on Finance of Economic Class Passenger Railways Public Services, Finance of Railways Infrastructure Maintenance and Operation, Finance of Railways Infrastructure Utilization (PSO, IMO and TAC) MoF Regulation 69/PMK.02/2007 on the Procedure of Provision, Disbursement, and Accountability of PSO Fund for Economic Class in Railways Transportation; MoT Regulation KM 44/1990 on the Tariff Policy for Passengers and Goods Transportation that has been amended by MoT Regulation KM 8/1995 MoT Regulation KM 29/2007 on the Tariff for Economic Class Railways Passenger Transportation with Air Conditioner Facility MoT Regulation KM 7/2009 on Tariff for Economic Class Railways Passenger Transportation MoT Regulation 41/2009 on the Provision of PSO for Economic Class Railways Passenger Transportation in 2009	Law 23/2007 on Railways Government Regulation 72/2009 on Railways Traffic and Transportation

The PSO/PS Policy position is also contained in Law no. 19/2003 on SOEs. It states that:

- the Government may order a special assignment to an SOE to manage a function of public benefit (but having regard to the objectives and purposes of the SOE's business activities).
- the special assignment is reviewed by the assigned SOE, Minister of SOE, MOF, and Sector Minister.
- if the special assignment is not profitable, the Government must provide compensation for all costs expended by the SOE, including the expected margin.
- each special assignment is subject to a General Meeting of Shareholders and Ministry of SOE approval.
- the assigned SOE is required to establish an account for the special assignment that is separate from its common business activities account.

The major policy platform that has been mentioned by most of the interviewed people in the MOT is “Access for all” policy of the GOI in the transport sector. That policy position embodies a key principle for the development and continuation of PSOs and PSs in transport.

PSO and PS Policies in Indonesia have been subject to substantial reports over the past three to four years, but the position on PSOs and PS remains unresolved between the key organisations of Bappenas, MOF and MSOE. The key issues are:

- Formation of the basic policy position;
- the formula for calculating PSOs and PSs;
- the institutional responsibilities.

The most recent Report of the ADB² found that there is a lack of clear objectives and the fact that “many of the currently socially oriented activities have been initiated through politically motivated processes to serve political interests”. In relation to measuring PSO arrangements “linkages between the level of subsidisation and the outcome of subsidised activities are weak”.

What is missing from the policy expression in the Indonesian law is the initial question being asked: What is the reason for the PSO or PS?

Indonesia is not on its own in this context. The Organisation for Economic Cooperation and Development (OECD) Roundtable Report³ clearly indicates that political decision-making in relation to PSOs is an issue within many countries – the USA, Canada and some member States for the European Union. The transparency of decision-making is equally challenged. Measurement of impacts is also weak.

There is an inconsistent approach to PSOs and PSs across the new transport sector laws and the new PSO and PS Policy will be constrained by the new laws, especially in the costing approach to be adopted. Harmonisation of requirements will be one of the key targets in the policy approach.

The sheer volume of laws points to a substantial over-regulation of a policy that really does require a more straightforward approach. The regulatory framework does need significant adjustment and from that position a straightforward approach can be developed.

Key policy positions that are obvious in the context of PSOs and PSs (and especially transport arrangements) but remain unstated are that in the more remote areas of Indonesia they are critical to maintaining those remote places within the sovereignty of Indonesia. Harmony and peace can be generated through the State providing transport access services to remote areas. This policy position is important to the direction of the policy and needs to be stated in the definition, so PSOs and PSs will be pointed in that direction.

This entire environment indicates that action is needed along the following lines:

- A common policy for PSOs and PSs in the transport sector is needed with a regulatory framework and a decision process that is designed to meet the needs of the policy (prepared under the new transport sector laws).

² ADB TA 4728-INO: Support for Infrastructure Development: PSO Policy and Roadmap. Final Report February 2008

³ Report of the OECD Roundtable on Non Commercial Service Obligations³, 2003

- Selecting a timeframe when the current regulatory regime is put aside in favour of a more straightforward approach.
- The development of a transition strategy and plan to adopt the new policy position that is agreed as a result of this project.

3.1.3 The Current Process

The current processes for developing and managing PSOs and PSs are set out in the following diagrams.

Diagram 9: PSO through direct assignment to SOE

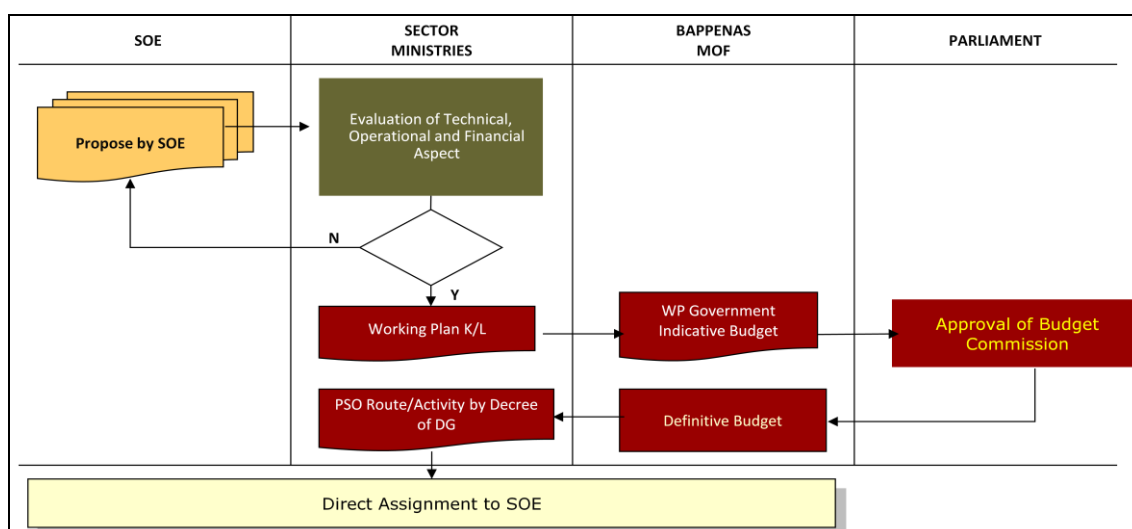
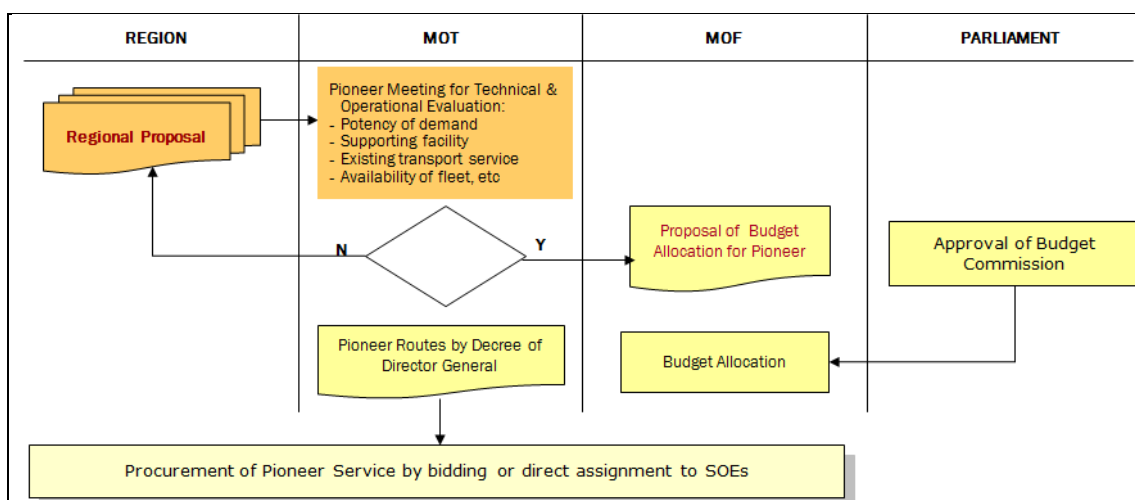


Diagram 10: Pioneer Services, Ministry of Transport



A brief analysis of the process shows the following issues that need to be addressed:

- The existing process for developing or reviewing a PSO or PS begins with a proposal by the relevant SOE or the private provider in the case of a PS. However, this may not be the right starting point. These are the service delivery organisations. While they may have valuable

information about the PSO/PS being delivered, it is not the logical commencement point. The logical commencement point is the regional government or the subsector directorate within the MOT, when the issue is a national issue.

- PSOs and PSs are currently not included in the national planning approach. PSOs and PSs have significant budget impact and economic impact within a regional context and the “Infrastructure for All” Policy of the GOI. Inclusion in the national planning process is essential.

3.1.4 Knowledge of the PSO Market

There appears to be a lack of knowledge of the PSO and PS market – both in terms of their size and composition. Surveys on the market are limited and do not include nor analyse issues such as ability to pay, preference surveys and willingness to pay. While all of these surveys are not needed in every case, knowledge of the market and assessment of regional development plans is not undertaken in sufficient depth to assess the economic value or the potential market of PSOs or PSs. Without that assessment, economic gains or costs and financial requirements cannot be adequately assessed⁴.

There is evidence in GOI Reports that in relation to PELNI and KAI:

- the market is assessed at a particular level by the relevant SOE;
- the funding is provided at either that level or lower;
- the market as audited by the Government Auditor indicates for PELNI a lower market than that estimated, but for KAI the market is substantially higher.

If the GOI continues to move to private sector implementation of PSs and introduces PSOs to the private sector, then it must have a greater knowledge of the market it is serving with the PSOs. This is a basic concept built on the principle of the GOI being a ‘knowledgeable purchaser’. It must have a good knowledge of the market and what the market costs are before it places a contract with a service provider (private sector or SOE).

The problems associated with a lack of market knowledge are essentially the following:

- If there is no certainty about the market size then there can be no certainty about the cost of the PSOs/PSs to government. So, the PSO/PS liability is not capped by a defined market - the subsidy is open-ended rather than determined by a well articulated subsidy policy.
- It is problematic to put out to tender a PSO/PS proposal that does not have the market defined and so the budget remains undefined. If the budget is set but exceeded, then a decision is required – continue to fund the PSO or stop the funding of the PSO/PS at the budget. This leads to an uncertain business proposition for the service deliverer and a less attractive business proposition.

3.1.5 Broad Conclusions

⁴ Note. CMEA Report in 2006: Compensating BUMNs for their Public Service Obligations recommends that near term budgetary costs and to the extent possible the expected benefits to service users should be a minimum assessment for PSO proposals.

All of the issues raised in this assessment point to the development of a PSO/PS Policy Position that incorporates the following principles:

- A definition of a PSO/PS is required.
- A competitive approach to service delivery is needed.
- An economic and financial evaluation of existing and proposed PSOs and PSs is needed.
- Better market knowledge is required.
- Higher level regional participation is needed in deciding PSOs and PS in particular, with a lessening of SOE influence.
- A multi-years contract is required if the private sector is to be encouraged to participate in service delivery.

3.2 THE PUBLIC SERVICE OBLIGATION AND PIONEER SERVICE POLICY

3.2.1 Introduction

From international research, the approach to PSO and PS policy and management varies from country to country based on the reason for the PSO and PS policy. Good practice exists in the transparent management of PSOs and PSs. The adoption of performance measures and auditing of outcomes are key factors in program success, especially in refining targets and increasing or decreasing PSO and PS targets and funding.

Contracting in some form is essential to establish the obligation to deliver PSOs and PSs competently and efficiently. And a competitive structure for the delivery of PSOs enhances the Government's capacity to obtain effective results. Output based programs⁵ are able to be developed, delivered and measured.

3.2.2 The Policy Basis

The essential policy aspects of PSO and PS Policy and Institutional arrangements are:

- Establish the reason for PSOs and PSs. This is the cornerstone of Policy development, funding and measurement.
- Define (clearly) a PSO and PS within the context of Indonesia. The definition will be the source of the detailed Policy for PSOs and the implementation approach to that policy;
- Establish institutional arrangement and decision-making paths that are clear and accountable (for example, introducing Government organisations into the decision-making role for which they are not accountable, is not an example of good institutional practice);

In addition to those basic elements, the policy position should also incorporate the following principles:

- Developing a definition of a PSO and PS that applies across the transport sub-sectors – one that produces a common understanding of a PSO and a PS and what the obligations of the

⁵ The principles of Output Based Aid are said to be relevant to PSO arrangements – ADB TA Report and the GREAT Working Paper No 3.

government will be (including the inclusion of the Access for All policy and the notion of PS assisting in Regional Connectivity);

- Introducing a transparent governance approach for developing, assessing, purchasing and measuring PSOs and PSs;
- Continuing the current GOI move to implementing a competitive delivery approach for PSOs and PSs and encouraging the participation of the private sector with a parallel lessening of direct assignments to SOEs;
- Developing market knowledge and expertise by the MOT in order to generate a competitive market for delivering PSO and PS services (MOT as a 'knowledgeable purchaser');
- Establishing a Business Case approach to the packaging⁶ and delivery of PSOs and PSs;
- Allocating clear roles and responsibilities between the MOT, Bappenas, MOF, MSOE and Regional Governments;
- Implementing a policy and process arrangement that sees PSO and PS development generated at a regional level and not by SOEs/private providers;
- Moving the structure of the (ample) law from an inputs based regime to an PBC system for PSO and PS delivery on a multi-years basis;
- Harmonising PSO and PS Policies and Regulations;
- Developing a standard form of contract for delivery of PSOs and PSs that applies to all services providers – whether they are private sector or SOEs – with performance measures and monitoring standards;
- Developing a transition strategy from the old law to new arrangements.

3.2.3 The PSO and PS Policy

Policy Source

The Policy source is Sections 33 and 34 of the Constitution and the sector laws relating to rail, shipping, land transport and aviation.

The Definition

The proposed definition of a PSO and a PS is drawn from the ADB Study⁷. It is the normative definition and one that generally applies the principles recommended by the OECD and it is close to the current Indonesia law definition. The proposed definition is as follows:

- A PSO and PS arise when a government explicitly requires activities that a service provider would not elect to do on a commercial basis and are not required of other businesses in the public or private sector.

⁶ Packaging means developing a potential business with appropriate service delivery requirements and contracts for service delivery

⁷ ADB TA 4728-INO: Support for Infrastructure Development: PSO Policy and Roadmap.

- PSO and PS relate to the government directed provision of infrastructure related services to disadvantaged groups such as the poor or geographically isolated.
- The government is classified as a 'purchaser' of such services from public (government owned) or private service providers.
- The purchase of PSOs and PSs requires explicit and approved funding.
- The purchase of PSOs and PSs will be implemented through output based contracts that will be competitively tendered.

The Policy Principles

There are five policy pillars for implementing a PSO and PS Policy for Indonesia. They are derived from the Workshop held in Bandung on 4 March 2010 and they incorporate issues that are specific to Indonesia and its particular needs.

Access for All: This concept is based on the MOT policy of Access for All. It provides for policies to target the poor of Indonesia and enable them to have access to safe and efficient transport services at an affordable price. It is also aimed at providing safe and efficient transport services to enable the remote regions of Indonesia to be developed for the betterment of the economy and to assist in the creation of markets and employment for the people who live in remote areas.

Regional Connectivity: PSOs and PSs (and especially transport arrangements) in the more remote areas of Indonesia are important to maintaining those remote places within Indonesia within the sovereignty of Indonesia. Harmony and peace can be generated through the State providing transport access services to remote areas.

Transparency: The development of a transparent approach to setting PS and PSO tariffs complies with best international practice in good governance principles. It is aimed at improving service delivery effectiveness and to minimise deviation from policy objectives resulting from unnecessary political interference.

Rationalisation of Tariff Gap Compensation: Rationalising the gap for the economic tariff class in order to increase fiscal space that will allow the growth of other programs and projects. It is a policy aspiration of targeting the progressive reduction of the PSO Gap funding over a nominated period so that the economic tariff and the commercial tariff for economic services are the same (similar to that of economic buses in Jakarta and the potential reduction of some PS in aviation, with a move to full commercial services tariffs). The policy is aimed at protecting fiscal space.

Competition: developing a competitive structure for the delivery of PSOs and PSs. The key principle is that PSOs should be competitively bid to the market and not be the sole province of SOEs. This principle applies to the delivery of PS and should apply equally to the delivery of PSOs.

The Policy Elaboration

The following section is about the actual operation and management of PSOs and PSs. It incorporates the targeting of PSOs and PSs, the development of a PSO or a PS and who is responsible for that role, the analysis of a PSO and PS to determine its economic value and its estimated cost to the GOI and the method of implementation (performance based multi-years contracts).

- **Application of the Policy:**
 - It applies to PSOs and PSs that are funded by the National Government. Individual Provincial Governments are free to adopt their own policy but it is expected that it will not conflict with this Policy.
 - It applies to the transport sector, and includes the subsectors of shipping, land transport, aviation and railways.
- **Targeting of PSOs and PSs:** for PSOs, the individual is the recognised beneficiary. All PSOs must be targeted to produce a beneficial effect to an individual and must be measured in that context. A PS must be targeted to the benefit of a region or district. The economic impact of a PS/PSO must be measured yearly and meet a hurdle investment rate of return. The hurdle investment rate of return will be set by Bappenas annually.
- **Principles of Developing and Implementing a PSO/PS:** Developing and implementing a PSO or a PS involves two principles:
 - The delivery of a benefit to an individual or to a region/district (as set out in the Policy Principles).
 - The preparation of PSO/PS delivery as a business which is capable of making a profit.
- **Responsibility for Developing a PSO or PS Proposal:** This differs according to the circumstance. The principle is to make the development process as a cooperative effort that involves a discussion between the regional and central governments, but the lead role will alter depending on the circumstances:
 - Development/Review of a PSO: responsibility will largely rest with the MOT. The MOT will be responsible for developing a business case for a new PSO. In relation to existing PSOs, the MOT will be responsible for their annual review with a particular focus on the financial aspects of the PSO – the delivery efficiency and the budget amount.
 - Development/Review of a PS: responsibility is allocated according to the following table:

Circumstance	Responsibility for Developing a PS Proposal
One regional government involved	The relevant regional government with a submission to the MOT
Two regional governments involved	A Steering Committee of the two regional governments and an MOU signed between the regional governments, with a submission to the MOT
Three or more regional governments involved	The MOT, through a Steering Committee, involving each of the regional governments. An MOU signed between the regional governments is required.

- **Evaluating a PSO or a PS:** the development of an evaluation tool for PSOs and PSs will be undertaken by Bappenas. The evaluation tool will be in the form of a Business Case (as defined later in this document) and will:
 - be able to assess the economic and social impacts of a PSO or a PS – both for new and existing ones;
 - contain a multi-criteria analysis for the selection/continuation of PSO or PS arrangements;

- incorporate cost/benefit analysis to determine the option which maximises the potential benefits from the introduction/continuation of a PSO or PS;
- incorporate a cost effectiveness analysis where benefits are difficult to measure in monetary terms.
- **Method of Delivery of PSOs and PSs:** the delivery of PSOs or PSs to the community will be undertaken through a competitive bid process. While the relevant sector legislation allows direct assignment of PSOs and PSs delivery roles to SOEs, that practice will be progressively eliminated. The GOI will develop PSO and PS business packages that are attractive to the private sector to deliver and will establish a contractual framework that is clear and transparent to the private sector, including secure payment mechanisms and processes and a multi-years arrangement.
- **Payment for PSOs and PSs:** the GOI will establish a process and mechanism in the MOT (and the process will be uniform throughout the various transport sub-sectors) for the secure payment of PSO and PS funds to providers (whether they are private sector providers or SOEs). The payment process will ensure that payments are made on normal commercial practice principles and will be detailed in the PSO and PS guidelines.
- **Transparency of PSOs and PSs:** the transparency of PSOs and PSs is an essential element of the policy framework. Transparency will provide for:
 - Open measurement of the delivery of PSOs and PSs, including their reaching the target 'customers' and their impact.
 - The capacity to review a PSO or a PS program and modify it to suit the recommendations of the review process.
 - The ability to deliver PSOs and PSs in a more cost effective way with budgets as a specific target.
 - The open publishing of the way PSOs and PSs operate in a transport sub-sector, including their availability, the funding, the tariffs associated with a PSO or a PS, the customers who gained a benefit and the impacts of a PSO/PS program.
- **Contracts for PSO and PS Service Delivery:** The delivery of every PSO or PS will be through a Public Service Contract (increasingly implementing a performance based multi-years contract) that will incorporate the following elements (see Appendix 1 which sets out a Contract Structure):
 - PSO and PS including definition of services (quantity, quality, timeliness and location, target group, eligibility criteria).
 - Contract Administration including terms and conditions of the contract or agreement (e.g. operating procedures indemnity and insurance default and termination).
 - Costing including costing methodology (including reference to specific costing studies), indexation responsibility and timing of reviews, administration costs, community service delivery costs.
 - Payment to the service provider.
 - Performance monitoring.

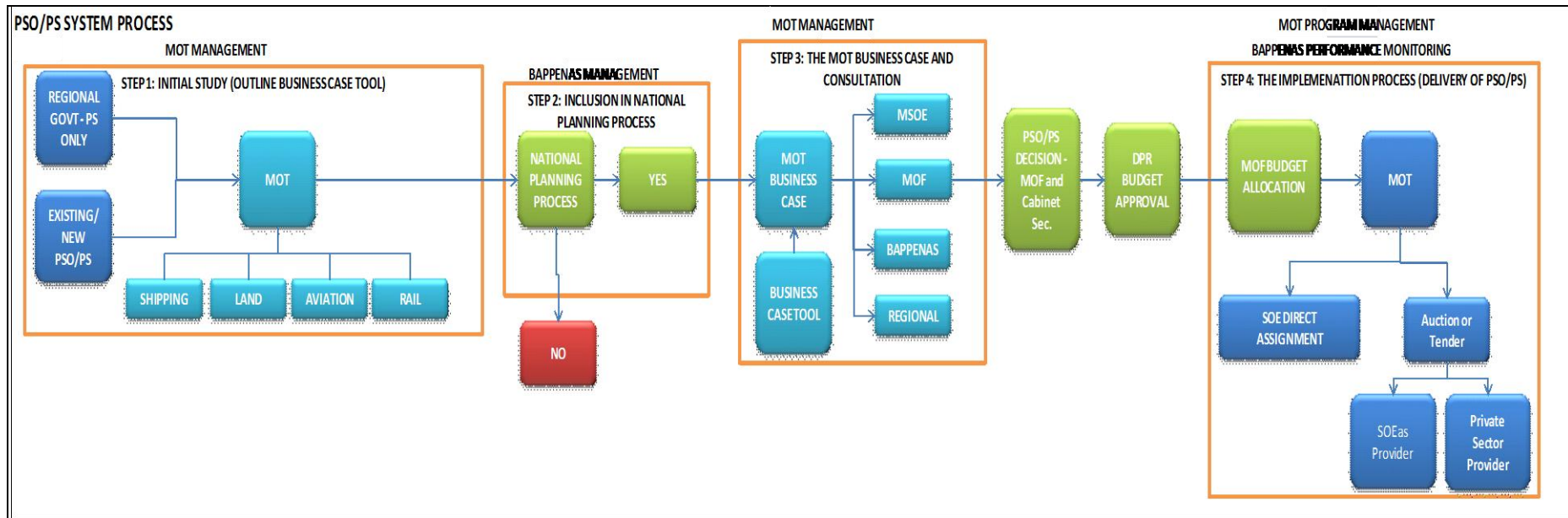
The Key PSO and PS Process

The process for developing and reviewing a PSO and a PS is one of the cornerstones of the Policy. The process and the allocation of responsibility create a high degree of transparency and predictability in applying the actual Policy content. Without the process being specified within the Policy, the Policy itself loses some of its capacity for clear and accountable management.

The principles embodied in the process are:

- Generation of PS proposals at the regional level and not by the relevant service provider.
- The MOT will generate the Business Case for a PSO, including the review of a current PSO.
- The introduction of the Business Case approach to evaluating a PSO or a PS proposal – the Business Case evaluates the economic impact and the financial costs and the fiscal budget impact of a proposal.
- The incorporation of PSOs and PSs in the national development planning process.
- The option of delivery of PSOs and PSs through the private sector.
- The harmonisation of the process for PSOs and PSs.

The key process for developing and implementing PSOs and PSs is as follows.



The Business Case

A Business Case is a technical evaluation of a service delivery proposal for either PS or for the establishment/movement of an economic tariff in the context of a PSO. The Business Case is used as a tool by management decision-makers to decide if a service delivery proposal:

- is in accordance with GOI Policy and how it meets the objectives of GOI Policy;
- provides economic and social benefits to targeted beneficiaries;
- utilises the allocation of government resources, including budgets, to provide for service delivery.

Undertaking a Business Case helps the government understand the market it is providing the service to and its potential growth. It also helps the government understand that the provision of PS or setting economic tariffs is a business that is capable of delivery by the private sector. In that respect, the delivery of the service must be commercially viable for the private sector to undertake the role of being a service provider.

The output of a Business Case is a document that assesses a PSO or PS proposal in the context of the following issues:

- Whether the proposal meets the policy objectives of “Access for All” as expressed in the MOT to target the poor of Indonesia and enable them to have access to safe and efficient transport services at an affordable price.
- Whether it meets the policy objectives of “Regional Connectivity” in the more remote areas of Indonesia in helping to maintain those remote places within Indonesia within the sovereignty of Indonesia.
- The estimated economic benefit to Indonesia resulting from the PSO or the PS. The benefits are quantified in terms of travel demand, aggregating different benefits and measuring whether this is a positive or negative impact, and the direct impact on poverty.
- The estimated cost of the PSO or PS and the financial case, including a recommended budget strategy.

The Institutional Responsibilities

The institutional arrangements are derived from the process. There are five key roles to play:

- Bappenas – Policy Owner and Performance Monitoring at a Fiscal Level and Program Delivery Level. Responsible for formulating cross-sector policy, prioritisation of cross sector programs and indicative sector budget.
- MOF – focus on fiscal monitoring of all PSOs and PSs in transport. Responsible for allocating and disbursing budget to the MOT for PSOs and PSs, based on fiscal consideration.
- MOT – Program Manager and manager of PSO and PS Contracts, including specific contract service performance and responsible for formulating and implementing sub-sector policy, programs and regulations.
- Regional Government – will generally be the initiator of PS proposals or in the case of three or more connected regional governments, the MOT will assume the responsibility.

- Service Deliverer (including SOEs) – PSO and PS delivery within budget and efficiently. Effectiveness is measured by both the Service deliverer and MOT.

The role of MSOE will be the current one where it will guard the commercial viability of SOEs in the delivery of NCSs.

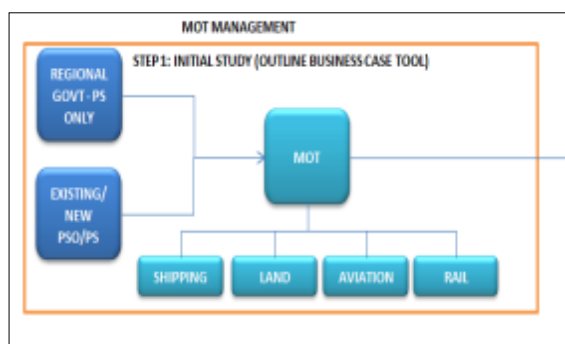
The Process and Guidelines

The following diagrams break-down the process set out above into logical steps. Guidelines will be developed for each step and the guidelines will apply across the transport subsectors:

Step 1: Initial Study (OBC)

The generation of a PSO or PS Case commences either with:

- the regional government on the basis of a demonstrated need in accordance with MOT guidelines and the definition of PSO/PS; or
- the review of an existing PSO/PS at regional level or within the relevant sector of the MOT.



The roles are divided as follows:

- Development/Review of a PSO: responsibility will largely rest with the MOT. The MOT will be responsible for developing a business case for a new PSO. In relation to existing PSOs, the MOT will be responsible for their annual review with a particular focus on the financial aspects of the PSO – the delivery efficiency and the budget amount.
- Development/Review of a Pioneer Service: responsibility is allocated according to the following table:

Circumstance	Responsibility for Developing a PS Proposal
One regional government involved	The relevant regional government with a submission to the MOT
Two regional governments involved	A Steering Committee of the two regional governments and an MOU signed between the regional governments, with a submission to the MOT
Three or more regional governments involved	The MOT through a Steering Committee involving each of the regional governments. An MOU signed between the regional governments is required.

The OBC will indicate:

- if the PSO/PS is warranted and it meets the definition of a PSO/PS;
- the target customers for the PSO/PS;
- the economic benefit to be provided through the PSO/PS;
- the prospective budget required for the PSO/PS;

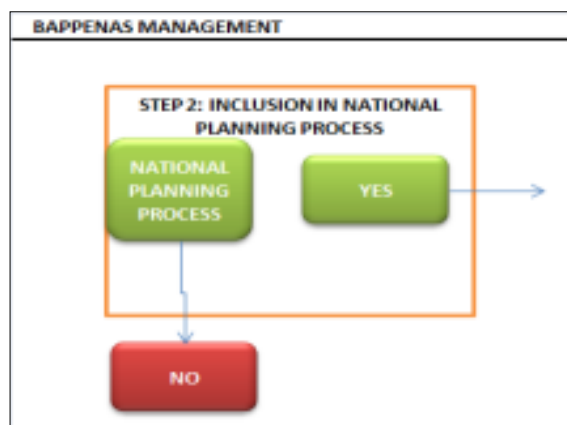
Step 2: Inclusion in the National Planning Process:

The MOT sends the OBC to Bappenas for inclusion in the national planning process:

- on the basis of a demonstrated need in accordance with MOT guidelines and the definition of PSO/PS; or
- with the review of an existing PSO/PS at regional level or within the relevant sector of the MOT.

The MOT will certify compliance with the guidelines that the PSO/PS meets the definition requirements and the purpose of a PSO/PS. The OBC will include:

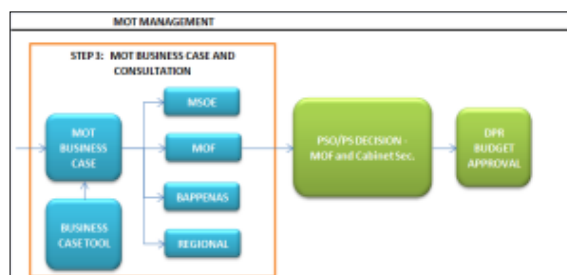
- the PSO/PS is warranted and it meets the definition of a PSO/PS;
- the target customers for the PSO/PS;
- the economic benefit to be provided through the PSO/PS;
- the prospective budget required for the PSO/PS.



Step 3: The MOT Business Case

The MOT develops the final Business Case for PSO/PS after the national planning process has agreed to its inclusion. The Business Case includes:

- if the PSO/PS is warranted and it meets the definition of a PSO/PS;
- the economic analysis
- the target customers for the PSO/PS;
- the benefit to be provided through the PSO/PS;
- the prospective budget required for the PSO/PS;
- the bidding and contracting arrangements for the delivery of the PSO/PS - tendered out or direct appointment to an SOE;
- the reason for a direct appointment to an SOE;
- PSO/PS service delivery contract with the performance measures indicated;



The MOT is obliged to forward the Business Case to the MSOE, Bappenas and the MOF. Their roles are to:

- for MSOE - in the case of a direct assignment only, agree that the PSO/PS can be delivered for the estimated cost and not impede the financial viability of the SOE.
- for the MOF - that there is fiscal space for the PSO/PS to be delivered.
- for Bappenas - that the Business Case conforms to the National Planning Approval Process decision.

Step 4: The Implementation Process

There are three major roles to be played by the GOI:

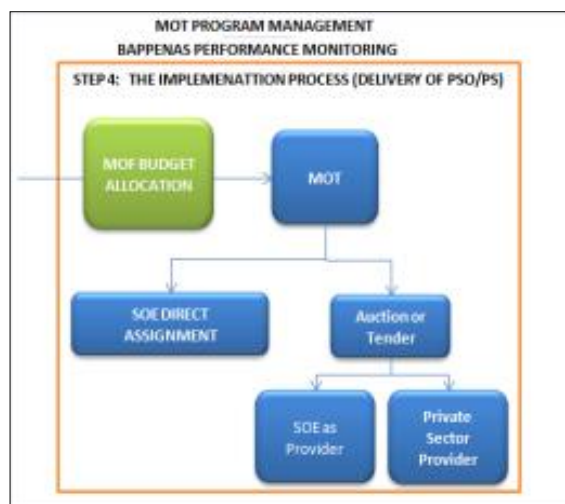
- Bappenas undertakes performance monitoring of the PSO/PS system, including fiscal monitoring and PSO/PS delivery. This accords within its management of the national planning process.
- MOF allocates the PSO/PS budget in accordance with the law on financial management.
- MOT manages the implementation of the PSO/PS through a contract based system.

Performance monitoring guidelines for Bappenas include:

- establishing performance benchmarks for each PSO/PS.
- undertaking an audit of the management meeting these benchmarks on an annual basis.
- ensuring that the MOT reviews the impact of the PSO/PS on an annual basis.
- budget monitoring by the MOF is undertaken in accordance with the Fiscal Law.

MOT management and monitoring includes the following activities:

- measuring contract performance in accordance with the PSO/PS contract and the approved Business Case/Budget;
- undertaking annual reviews of the performance of the PSO/PS contractor (which includes any direct assignment to an SOE);
- undertaking annual reviews of the performance of the PSO/PS and its need/revision;
- developing PBC for PSO/PS delivery.



3.3 IMPLEMENTATION PRINCIPLES AND STRATEGY

3.3.1 Implementation Strategy Principles

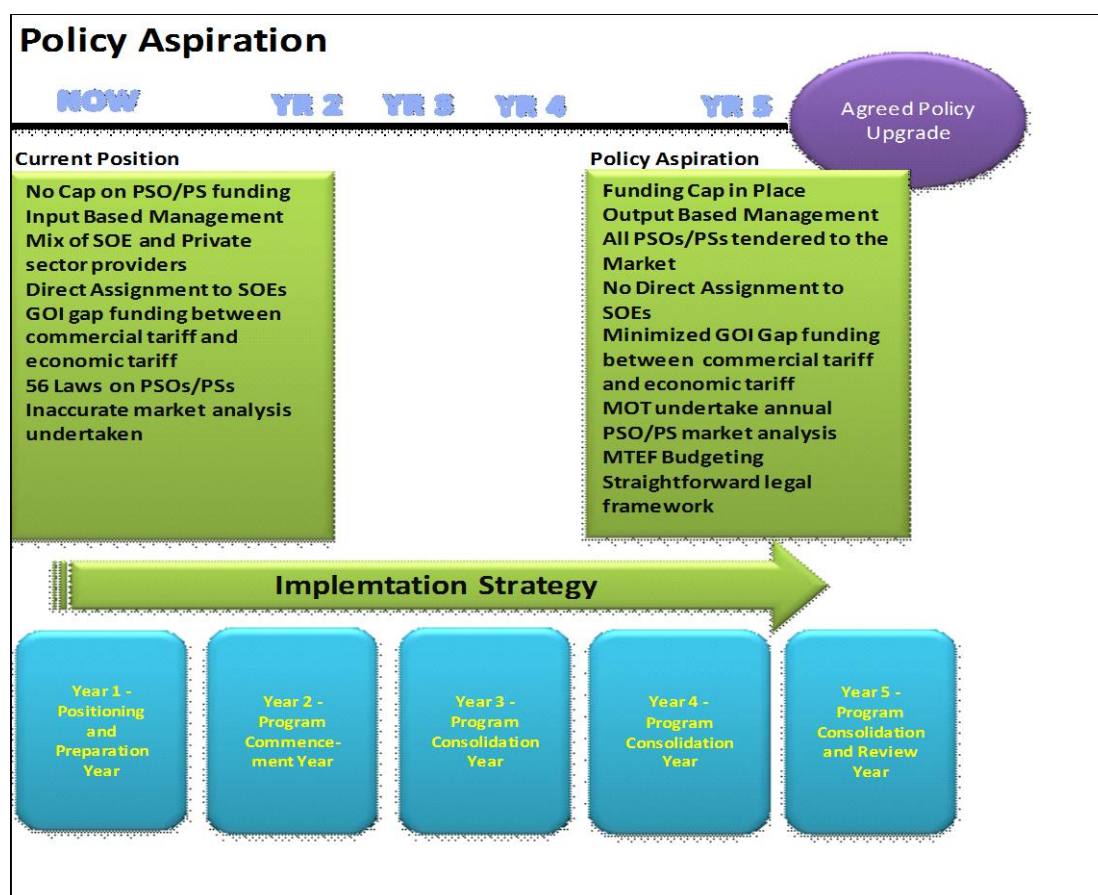
The introduction of the PSO and PS policy requires a staged approach. The Policy can be issued but with a plan for its introduction.

The principles for the Policy implementation that have been agreed are:

- An implementation strategy which will be agreed by Bappenas, MOT, CMEA, and MOF;
- Government will encourage private sector participation in PSO and PS, including multiyears contracts as appropriate to sub-sectors;
- Government will implement PSO and PS policy with more accountability and transparency according to laws and regulations.

This chapter deals with the implementation strategy and the following diagram sets out a basic implementation plan. More detailed work will be undertaken when the Policy and the basic plan has been agreed.

The diagram shows the position now and the policy aspiration. A five-year implementation plan is suggested with five stages to achieve policy implementation.



3.3.2 Implementation Strategy Stages

The following table describes each of the stages in the implementation plan:

Stage	Work Program
Year 1: Position and preparation year	<ul style="list-style-type: none"> Introduce the institutional approach for the development and review of PSOs and PSs, including the approach for reviewing a PS at regional government level. Undertake market analysis of 20 percent of PS routes. Undertake the review of the PSO for shipping. Commence the Business Case analysis. Prepare competitive tender documentation for both PSO and PS, including multi-years contracts. Define the MOT purchased fleet of ships for PSO and PS.

Stage	Work Program
Year 2: Program commencement year	<ul style="list-style-type: none"> • Undertake market analysis of next 20 percent of PS routes. • Tender out PSO and PS Services on an output based and multi-years contracts. • Formula for PSOs and PSs removed from the regulations. • Complete a review of all existing regulations (and other laws) and implement new regulations based on the PSO/PS Policy. • Introduce a funding cap for PSO and Pioneer Services (with fiscal risk allowance).
Year 3: Program consolidation year	<ul style="list-style-type: none"> • Undertake market analysis for the next 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Undertake and complete tariff gap rationalisation strategy.
Year 4: Program consolidation year	<ul style="list-style-type: none"> • Undertake market analysis for the next 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Test the gap rationalisation approach with the community (socialisation). • Establish the monitoring review framework for Year 5.
Year 5: Program consolidation and review year	<ul style="list-style-type: none"> • Undertake market analysis for the final 20 percent of PS routes. • Tender out the PS routes. • Review the PSO for shipping. • Commence PSO tariff gap rationalisation strategy. • Undertake program review and present findings.

CHAPTER 4: BUSINESS CASE GUIDELINES FOR PUBLIC SERVICE OBLIGATIONS AND PIONEER SERVICES

4.1 EXECUTIVE SUMMARY

Undertaking a Business Case to assist decision-making for a PSO or a PS is one of the cornerstones of the PSO/PS Policy. The Business Case is used as a tool by management decision-makers to decide if a PSO/PS service delivery proposal:

- Is in accordance with GOI Policy and how it meets the objectives of GOI Policy;
- Provides any economic and social benefits to targeted beneficiaries;
- Should be allocated government resources, including budgets, to provide for the PSO/PS service delivery.

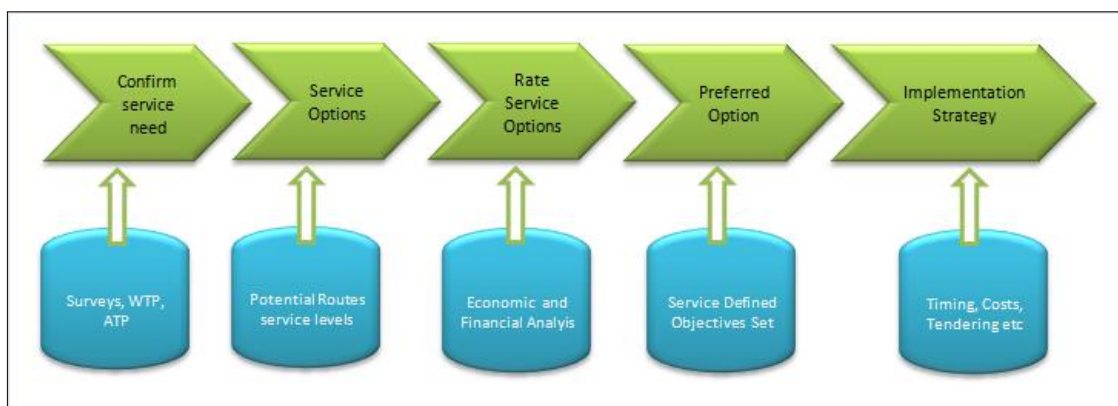
This Document sets out what is expected of a Business Case and which organisation is responsible for undertaking the Business Case. The Business Case approach only applies to PSOs and PSs that are funded from the national budget.

The Business Case format contained in this document is a simplified approach. As government becomes more familiar with this approach, the sophistication of the work undertaken in a business case will grow. For example, the market knowledge called for in the Business Case is not a formal and detailed demand survey or study. It is work that will identify the potential size of the market and apply some sensitivity and a risk approach to the potential demand.

It is recognised that at regional government level, there is generally not sufficient expertise available to undertake a full Business Case for PS or a PSO if that is applicable. With that position in mind, these Guidelines allocate responsibility between the relevant regional government and the MOT based on capacity and national roles.

The MOT is responsible for PSOs because they are a national issue. On the other hand, PS are generally regional government focused and the OBC (the initial Business Case work) is allocated at that level, except when there are more than three governments involved when the MOT is given responsibility.

The Business Case process is broken down into five easily identifiable steps as follows:



Each step is explained in the Guidelines and the expected outcome.

In summary, the Business Case answers the following questions, with economic and financial assessments as technical supporting information:

- whether the proposal meets the policy objectives of “Access for All” as expressed in the MOT to target the poor of Indonesia;
- whether it meets the policy objective of “Regional Connectivity” in the more remote areas of Indonesia;
- if there is a net economic benefit to Indonesia;
- whether Indonesia can afford to fund the PS or the PSO.

4.2 THE PURPOSE AND BENEFITS OF A BUSINESS CASE

4.2.1 What is a Business Case

A Business Case is a technical evaluation of a service delivery proposal for either PS or for the establishment/movement of an economic tariff in the context of a PSO. The Business Case is used as a tool by management decision-makers to decide if a service delivery proposal:

- is in accordance with GOI Policy and how it meets the objectives of GOI Policy;
- provides any economic and social benefits to targeted beneficiaries;
- should be allocated government resources, including budgets, to provide for PSO/PS service delivery.

Undertaking a Business Case helps the government understand the market it is providing the service to and its potential growth. It also helps the government understand that the provision of PS or setting PSO economic tariffs is a business that is capable of delivery by the private sector. In that respect, the delivery of the service must be commercially viable for the private sector to undertake the role of being a service provider.

Adopting a Business Case approach substantiates decisions. It creates a discipline of undertaking focused surveys and research work as inputs to the economic and financial cases. It significantly helps with organisational accountability for meeting policy objectives.

The output of a Business Case is a document that assesses a PSO or PS proposal in the context of the following issues:

- Whether the proposal meets the policy objectives of “Access for All” as expressed in the MOT to target the poor of Indonesia and enable them to have access to safe and efficient transport services at an affordable price;
- Whether it meets the policy objective of “Regional Connectivity” in the more remote areas of Indonesia in helping to maintain those remote places within Indonesia within the sovereignty of Indonesia;
- The estimated “economic benefit to Indonesia” resulting from the PSO or the PS. The benefits are quantified in terms of travel demand (the market is known and its potential growth is also known), aggregating different benefits and measuring whether this is a positive or negative impact, and the direct impact on poverty.
- The estimated cost of the PSO or PS and the financial case, including a recommended budget strategy (Multi-year budgets are able to be estimated);

- The legal contractual framework is recommended and clear (including multi-years contract);
- An implementation plan is drawn up and milestones and performance measures are identified and a monitoring plan is defined.

4.2.2 When to Undertake a Business Case

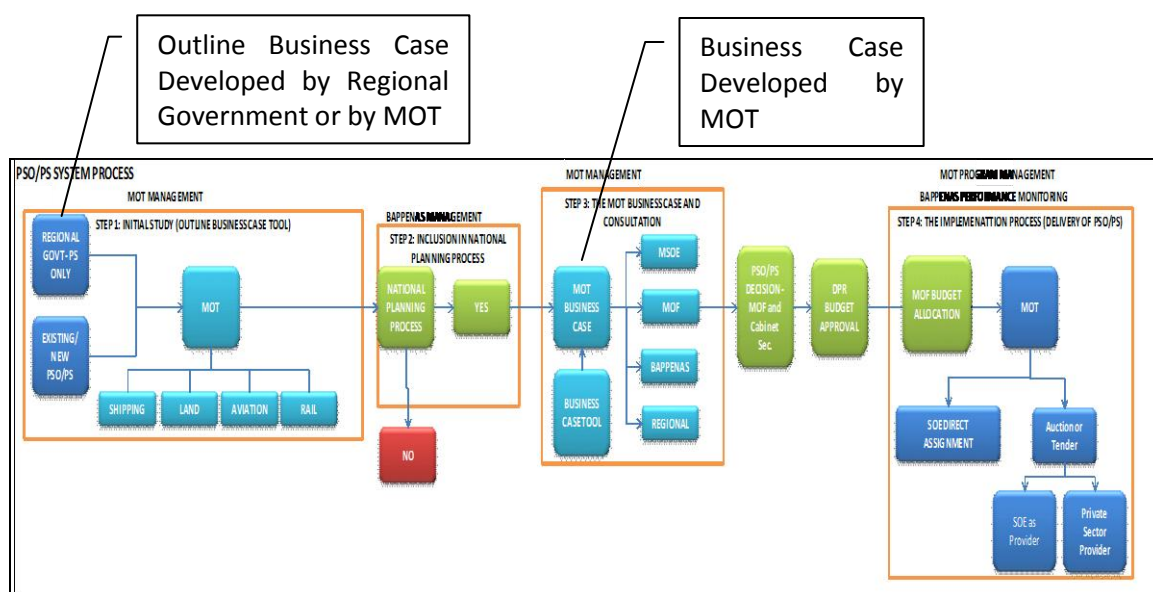
A business case should be prepared in the following circumstances:

- for the implementation of a new PS;
- for each PS in place now in order to review their effectiveness and efficiency and potential for a long term contract;
- for each year when it is proposed to set an economic tariff within the context of a PSO.

4.2.3 The Policy Context for a Business Case

The context for conducting a Business Case is the agreed Policy for PSO and PS.

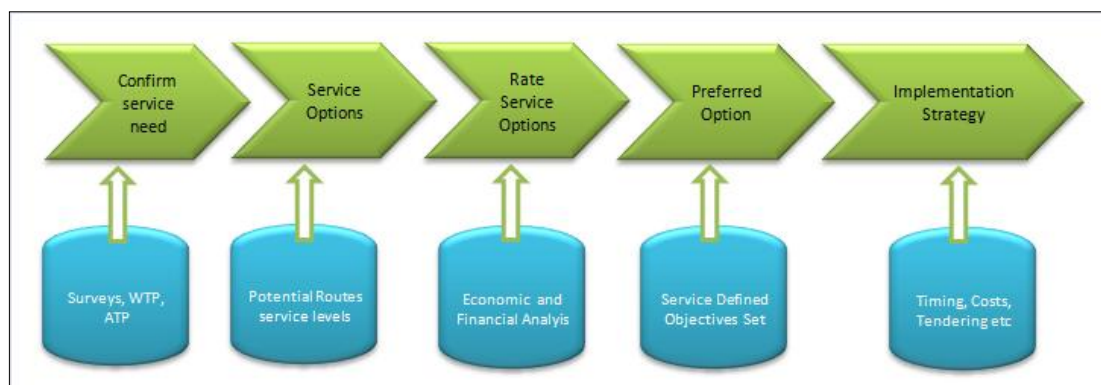
The Business Case is part of the Key PSO/PS process contained in the PSO and PS Policy. The process is set out below with an indication where the Business Case is to be undertaken:



4.3 BUSINESS CASE ELEMENTS

4.3.1 The Overall Approach to a Business Case

There are five key steps in undertaking a Business Case. The steps then convert into a structure for preparing the Business Case itself. The diagram below sets out the structure and the basic inputs into each step. It is generally appropriate for two or three options to be considered in the business case.



The diagram is explained in the steps below.

The Business Case also needs to incorporate an Executive Summary which is a stand-alone document at the front of the main body of the report. It provides:

- an outline of the proposal and the business concept;
- a summary analysis of the options and alternatives considered;
- details of the recommended option; and
- text, graphics, and tables of critical numbers should be used to present the key arguments and findings to decision makers.

4.3.2 Who is Responsible for the Business Case?

Responsibility for the development of the Business Case will vary according to circumstances. The PSO/PS Guidelines deal with this matter in more detail, but the basic position is as follows:

For the OBC - PS:

Circumstance	Responsibility for Developing a PS Proposal	Level of Work Required
One regional government Involved	The relevant regional government with a submission to the MOT	Defining the service proposal; Market numbers and appropriate surveys; Assessment of the proposal against the five policy pillars – Note broad economic benefits should be described and estimated financial costs should be provided. Risks should be identified (e.g., lack of demand etc).
Two regional governments involved	A steering committee of the two regional governments and an MOU signed between the regional governments, with a submission to the MOT	Defining the service proposal; Market numbers and appropriate surveys; Assessment of the proposal against the five policy pillars – Note broad economic benefits should be described and estimated financial costs should be provided. Risks should be identified (e.g. lack of demand etc.).

Circumstance	Responsibility for Developing a PS Proposal	Level of Work Required
Three or more regional governments involved	The MOT through a steering committee involving each of the regional governments. An MOU signed between the regional governments is required.	<p>Defining the service proposal;</p> <p>Market numbers and appropriate surveys;</p> <p>Assessment of the proposal against the five policy pillars;</p> <p>An initial economic and financial assessment should be undertaken using the model provided in the guidelines.</p> <p>Risks should be identified.</p>

For the OBC – PSO

The OBC for a PSO is developed and managed by the MOT. This is a nationally applied issue and requires the relevant Sub-sector Directorate of the MOT to undertake this work.

The OBC will deal with the following issues:

- Defining the PSO service case.
- Market numbers and appropriate surveys.
- Assessment of the proposal against the five policy pillars.
- An initial economic and financial assessment should be undertaken using the model provided in the guidelines.
- Risks should be identified.

For the Business Case - PSO or PS

The complete Business Case for a PSO or PS is the responsibility of the relevant sub-sector Directorate of the MOT.

4.3.3 Business Case Steps

Step 1: Confirm the Service Need

The objective of the proposal and its alignment with the GOPI and the department's strategic plan should be reaffirmed. This will include the analysis of the market for PS and PSOs, including the market size, willingness to pay and ability to pay. It is likely that this will vary from region to region.

This section details the project concept, which includes the project need and the problems or issues to be addressed. A clear, succinct description of all elements of outputs/service to be provided to meet this need must be set out. It should:

- explain the service need (information should be provided on the likely demand and charging policies to recover costs);

- identify the government policies and strategies at a national and local level that support the establishment of the service;
- specify the scope of services required to be delivered; and
- identify key success factors, opportunities and benefits. This includes assessing the full range of service outputs that may be included to enhance eventual value for money.

Key stakeholders need to be identified – that is the beneficiaries of the service and other affected people such as special interest groups, community groups, relevant local governments, relevant government departments etc. and the affect of the service delivery on them. This part of the Business Case should briefly outline:

- the consultation already undertaken and the key issues arising from that consultation;
- confirmation that key stakeholders who are providing information are able to certify the accuracy of information submitted and identify the source of the data used;
- actions/responses to stakeholder input as well as potential impact on the proposal.

Step 2: Scope the Service Options

This section will discuss the potential transport service options, for example potential routes, service levels per route, and issues such as the equalisation of services in a region (especially a remote area). The options must be aligned with the policy framework for non-commercial service provision.

This section should provide clear statements of the objectives and scope of the proposed initiative (i.e., what will be built/acquired with the capital) and its connection to the government (national and local) priorities and the department's strategic plan and Multi Year Strategy. It should provide:

- evidence of the degree to which the proposed initiative or program aligns to those priorities;
- key performance indicators for both, project milestones and outputs relating to the proposed initiative; (indicating how performance to meet quality standards, timing, costing and benefit realisation relating to the project objectives will be measured);
- adequate project monitoring framework including progressive performance measures and how the project will be monitored as it progresses and an outline of the type of post project evaluation. This will assist departments in assessing whether it has the capability to deliver the project.

This section incorporates an assessment of the options in the following way:

- generally two or three options should be considered; the two options which are most likely to deliver the desired outcomes and the 'do nothing' or minimal approach option.
- clearly identify the benefits, costs and consequences of each option (remembering that budgetary constraints may result in funding of an option other than the recommended one).
- information on the present service delivery performance/status and condition/ utilisation of existing infrastructure needs to be considered (if it exists).
- describe the impact on related services and assets and opportunities for integration with other government services demonstrating consideration of cooperative and coordinated government action.

- include information on whether the operation, or part of it, could be efficiently and reliably contracted out.
- if there are any interim or staged implementation solutions available.

Step 3: Evaluate the Service Options

This will include a cost-benefit analysis⁸, or cost-effectiveness analysis⁹, for the preferred option. The economic and financial analysis needs to address both, quantifiable and non-quantifiable costs and benefits in order to fully inform government decision making.

The analysis should demonstrate why the preferred option offers better value for money than other options, including a 'do nothing' option, to achieve the desired outcome. The business case should set out the significant underlying assumptions and estimates of the cost.

Critical assumptions or constraints for the proposal need to be documented.

- critical assumptions include revenue drivers, capital and operating costs, social factors, financing constraints, availability of resources and expertise.
- any known or emerging constraints directly impacting the proposed initiative should be included.
- regulatory, legislative, policy issues and relevant Acts which may constrain or limit the service proposal need to be identified, including information on where this may be a constraint.

It will generally rely on an economic/financial model appended to the business case that addresses whole of life costs (capital and operational) and benefits (financial or quantifiable economic). In addition, the analysis needs to integrate non-quantifiable economic, social and environmental costs and benefits.

An analysis of the social impacts of a proposal should:

- identify any significant social issues or opportunities directly attributable to the proposal.
- address aspects identified in the stakeholder analysis.
- outline the nature and extent of the impact on each group or individual.
- develop strategies and options to capitalise on opportunities and manage negative issues.

Issues identified in this analysis should be stated clearly in the business case so that they are transparent to decision-makers and inform them of any policy implications, employment opportunities or community impacts of the proposed initiative.

⁸ A cost benefit analysis is done to determine how well, or how poorly, a planned action will turn out. Although a cost benefit analysis can be used for almost anything, it is most commonly done on financial questions. Since the cost benefit analysis relies on the addition of positive factors and the subtraction of negative ones to determine a net result.

⁹ Cost-effectiveness analysis (CEA) is a form of economic analysis that compares the relative costs and outcomes (effects) of two or more courses of action. Cost-effectiveness analysis is distinct from cost-benefit analysis, which assigns a monetary value to the measure of effect. Typically, the CEA is expressed in terms of a ratio where the denominator is a gain and the numerator is the cost.

The extent and nature of the social analysis element of the business case should reflect the scope of the social impacts. Issues identified in this analysis should be stated clearly in the business case so that they are transparent to decision-makers and inform them of any policy implications, employment opportunities or community impacts of the proposed initiative.

Step 4: Recommend the Preferred Option

The rationale for the preferred option should build on the earlier evaluation of options with explicit reference to the performance criteria used to assess the preferred option.

A clear recommendation is required for the preferred option, clearly outlining the reasons for the recommendation.

A description of the preferred option and rationale for the recommendation should be provided. It should specifically deal with the question of whether the operation, or part of it, could be efficiently and reliably contracted out to the private sector or it should simply be referred to a SOE for the service delivery.

The other issues this section needs to address for the preferred option are:

- its major features, including the statement of purpose of the proposal;
- its scope;
- economic and financial analysis, including key assumptions;
- risk evaluation;
- social analysis;
- budget analysis and funding strategy;
- key performance indicators for both, project milestones and outputs relating to the proposed initiative; (indicating how performance to meet quality standards, timing, costing and benefit realisation relating to the project objectives will be measured);
- key project implementation issues, including risk management.

This section should also describe:

- the impact on related services and opportunities for integration with other government services.
- if interim or staged implementation solutions are available.
- whether the proposal, or some aspect of existing operation, can be scaled down or closed.

Step 5: Set Out the Implementation Strategy

Key features and steps to implement the preferred option must be specified and the basic requirements are set out in the following table:

Requirement	Basic Details
Management and governance structure	<p>The management and governance structure for the project should be specified. The decision-making process and steps should also be set out including nominating the decision maker within the responsible organisation. The structure should also include any committee structure where this has been recommended and agreed.</p>
Budget strategy	<p>The budget analysis must identify the operating budget (revenue and expenses) over the proposal's lifecycle and the capital cost impacts over its life (initial costs and any known renewals requirements) together with cash flows for each financial year.</p> <p>It should outline:</p> <ul style="list-style-type: none"> • the impact on the department's outputs and associated outcome targets (i.e. measurable impact on performance); • the cost impact including all changes to revenues and expenses (capital charging, depreciation equivalent as well as maintenance, security, cleaning etc.) and the impact on the net cost of agency outputs; • asset investment requirements; and • cash outflows and inflows, including explicit identification of the proposed funding sources and details of any financial arrangements including user charging.
Scheduled milestones and key deliverables	<p>A project delivery plan is needed that schedules milestones and the key deliverables for the project. The project plan will incorporate budget requirements and needs as well, for example payment schedules etc.</p> <p>The Project Plan should detail timing and delivery sequencing requirements and the potential lead-time expected. The plan will also deal with:</p> <ul style="list-style-type: none"> • project schedule information, including information on potential competing priorities; • skills, capabilities, and availability of agency staff; • contractor expertise and experience etc.; • resourcing implications for the department. • A monitoring and reporting plan should be incorporated
Risk Management	<p>The project risk should be broadly scoped and defined and then risk allocated between the government and the provider. The allocation of risk will generally be standard and apply in the same way to most projects/service delivery.</p> <p>However, if the government provides the asset to be used in service provision (e.g. a ship for PS) then the allocation of responsibilities for operation and maintenance will need to be specified.</p>

Requirement	Basic Details
Acquisition strategy	<p>The acquisition strategy is related to the delivery of PS and is dependent on the recommended option of the Business Case. There are two basic options:</p> <ul style="list-style-type: none"> • Open competitive tender for the service provision; • Direct allocation to a SOE. <p>The Business Case will discuss and determine the strategy. Long term contracts for service provision must also be considered and determine the acquisition strategy.</p>
Performance targets	<p>Performance targets will be derived from the economic and financial evaluation results of the Business Case. The targets will include issues such as:</p> <ul style="list-style-type: none"> • Frequency of service (including a non-delivery percentage); • Number of passengers served versus the estimates; • Regional economic growth (for pioneer services); • Cost of service, including the cost per person for delivering the service versus the estimated; • The safety record in delivering the service; • The budget estimates versus the actual expenditure.

4.4 BUSINESS CASE SIGN OFF

It is important that the primary author of the business case is identified and signs it off. Reviews of the Business Case should also be identified.

ANNEXES

ANNEX 1: STRUCTURE OF PSO CONTRACT

ATTACHMENT 2: CSO Contracts

CSO contracts are simply contracts for the delivery of certain services to the community. These contracts should be established between the Department⁶, acting on behalf of Government, and the organisation responsible for providing these community services. In structuring a CSO contract and negotiating this contract with a service supplier, agencies should consider some of the following important elements⁷.

Community Service Obligations

- definition of services (quantity, quality, timeliness and location)
- target group
- eligibility criteria
- customer information/consumer charter
- service level incentives

Administration

- terms and conditions of the contract or agreement
- dispute resolution procedures
- definition of change events and adjustment mechanisms
- contract variations
- subcontracting/agency provisions
- default and termination
- confidentiality
- force majeure
- indemnity and insurance
- operating procedures
- legislative provisions

Costing

- costing methodology (including reference to specific costing studies)
- indexation
- responsibility and timing of reviews
- administration costs
- community service delivery costs

Payment

- billing arrangements (invoice, cycle)
- funding method
- timing of payments
- payment terms
- price

Performance monitoring

- performance measures
- reporting arrangements (timing)
- customer complaints procedures
- auditing

Other

- training requirements
- information and intellectual property