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Transforming the BUMN into an Indonesian State Holding Company

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Senior Fellow, Asia Energy and Sustainability Initiative

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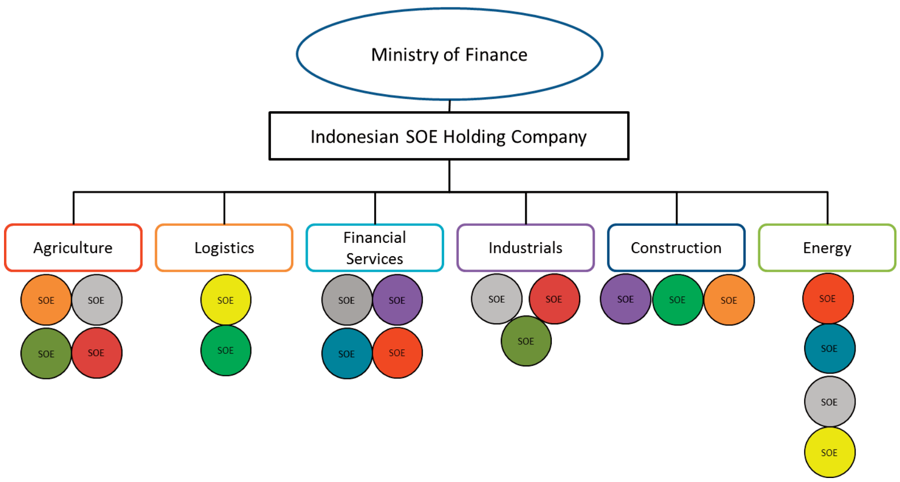
Ministry of Finance
Indonesian SOE Holding Company
Agriculture
Logistics
Financial Services
Industrials
Construction
Energy
SOE

EXECUTIVE SUMMARY

This report argues for a state holding company structure to hold all state-owned enterprises (SOEs), in a drastic revamp of the Badan Usaha Milik Negara (BUMN).

The time is ripe for a fundamental rethink of the structure of SOEs in Indonesia. With a proliferation of SOEs in large swathes of the economy, there is great potential to extract greater value from these companies. In brief, the formation of a Temasek-style Indonesian SOE holding company will achieve better corporate governance, performance control and strategic direction for these SOEs. The SOE holding company will embody the profit-maximizing and value-creating urges of a private company while ensuring that government ownership of strategic assets is maintained.

The compelling case for a single holding company.

- The government will exit the direct management of SOEs to allow a profit-driven, commercial company to achieve that goal. Government will focus instead on its proper role as a policymaker/regulator, avoiding potential “crowding out” effects and conflicts of interests.
- Economies of scale and scope can be harnessed from the consolidation of SOEs under a parent holding company, for example through centralizing shared services such as skills training and technology development under the parent company. This will include the consolidation of all professional services such as Sucofindo, Penas, PTSI etc. as a sub division of the parent holding company.
- Such a structure can also better ensure a coherent strategic direction among the subsidiary companies, in line with national policy goals.
- It would also allow for greater access to financial resources and more efficient capital allocation in order to invest in productive assets for long-term profitability and to latch on to opportunities in international markets.
- Market forces and opportunities will guide the activities of Indonesian SOEs and this will compel them to make the necessary gains in efficiency and productivity or risk being completely eliminated from the market.

Structure of the SOE holding company

A SOE holding company in the mould of Singapore’s Temasek Holdings is proposed below.

The parent company will serve as the HQ for corporate oversight and governance. It will also centralize shared services such as human resources, R&D, professional services and training. In essence, the holding company will strive to ensure strong and capable leadership within each subsidiary, and excel in their respective sectors through feasible business strategies and value creation. It also seeks to optimize the competitive and regulatory landscape by virtue of its clout. By macro-managing, the holding company monitors each subsidiary SOE's performance while allowing each of them to execute their own decisions. When scope for cooperation arises, the holding company can serve to bring together relevant parties in joint ventures.

SECTION 1

The Value-Add of a Temasek Holdings-Style Company for Indonesia

1.1 The key features of Temasek Holdings

Temasek Holdings is an investment company owned by the Government of Singapore. It acts principally as Singapore's holding company for virtually all state-owned enterprises (SOEs) in a broad spectrum of industries: financial services; telecommunications, media and technology; transportation and industrials; life sciences, consumer and real estate; as well as energy and resources. Since its inception in 1974, total shareholder return was 16% compounded annually [1], delivering respectable returns for its sole shareholder—Singapore's Minister for Finance[2].

In the early 1960s, the Singapore Government embarked on an industrialization drive to boost the fledging economy of newly independent Singapore. The public sector assumed an entrepreneurial role in which it co-invested in companies in various sectors to encourage inflows of foreign direct investments as well as to facilitate technology transfers from joint ventures with foreign multinational companies. Some of these sectors were of strategic and national importance to Singapore's well-being.

The creation of Temasek occurred in the context of rapid industrialization in the 1970s, when the Government decided to adopt a more macro view of the economy and to focus on policymaking, instead of behaving like a venture capitalist. Previously, assets owned by the state were directly held by the Singapore Government under the Ministry of Finance. However, in order to allow the Ministry to focus on its core responsibilities of prudent policymaking and enforcing regulations, Temasek was incorporated in 1974 to hold and manage state investments and assets on a commercial basis. It also allowed the Singapore Government to manage Government-Linked Companies (GLCs) at arms' length, reducing the government's footprint in the private sector and allowing market forces to thrive in a competitive environment. In other words, the government does not "interfere with the operations of the GLCs" and GLCs "operate as a commercial entities".

As a key institution in Singapore, Temasek is also designated a Fifth Schedule entity under the Singapore Constitution, with certain safeguards to protect its past reserves. Any transaction which is likely to result in a draw of Temasek's past

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1 *http://www.temasek.com.sg/abouttemasek/corporateprofile*

2 Under the Singapore Minister of Finance (Incorporation) Act (Chapter 183), the Minister for Finance is a body corporate.

reserves is subject to the approval of the President. This is meant to prevent a financially imprudent government from squandering past reserves.

The incorporation of Temasek Holdings reflects the early realization by Singapore's leaders that its enterprises needed to be run commercially in order to be successful. Temasek is run as a commercial company and is neither a statutory board nor a government agency. Under the Singapore Constitution, Temasek safeguards past reserves accumulated before the current term of government. The President's approval is needed before a draw on past reserves can occur. Regular intervals of reserves certifying statements to the President are mandatory. Other than specific safeguards to protect the integrity of Temasek board appointments and its past reserves (given its importance to the nation), Temasek continues to operate fully and independently as a commercial investment holding company.

1.2 Current context

Temasek Holdings is currently one of the world's largest sovereign wealth funds and has investments spanning six continents and many industries. While it still manages the strategic and legacy assets of the Singapore Government, Temasek has successfully ventured internationally in search of potentially lucrative investment opportunities. Additionally, Temasek also contributes to the Singapore Government Budget from its investment returns.

The investment company's holdings are currently categorized into five main segments: 1) Financial Services; 2) Telecom, Media & Technology; 3) Transportation & Industrials; 4) Life Sciences, Consumer & Real Estate; and 5) Energy & Resources.

The sovereign wealth fund takes on the role of an engaged shareholder by managing its portfolio as an active investor by increasing or decreasing its investment holdings to create and shape risk-adjusted returns for the long term. Temasek protects its own interests by exercising its shareholder rights, including voting at shareholders' meetings where needed.

Temasek's portfolio companies are guided and managed by their respective boards and management teams. This means that the holding company directs neither their business decisions nor operations. From a portfolio point of view, it monitors and benchmarks the returns and performance of each company in comparison to its peers, and expects each of its portfolio company to make disciplined decisions based on sound business interests.

Board Members of Temasek are appointed, reappointed or removed by the Minister of Finance. The President's concurrence is required to provide an additional layer of insulation from any undue government influence.

Temasek is not directly represented on the boards of its portfolio companies. Rather, it promotes sound corporate governance in its portfolio companies by supporting high calibre, commercially experienced and diverse boards to complement management leadership. By leveraging its wide network of contacts, Temasek is able to suggest qualified individuals for consideration by the respective boards. Temasek employees would be appointed to boards of directors in their own individual capacities, and are expected to meet their fiduciary responsibilities.

Temasek advocates that boards be independent of management in order to provide effective oversight and supervision of management. This includes having mostly non-executive members on boards with the capability and experience to oversee management. It also advocates that separate persons, independent of one another, hold the Chairman and CEO roles in a company. To date the Temasek Board Members consist of former and current civil servants, but the majority come have business backgrounds.

In 2009, it was announced that as Temasek's stakes in overseas holdings increase, the investment holding company would seek to work more closely with its portfolio companies—i.e. there may be actions taken at board-level to enhance the firm's value in order to maximize returns on Temasek's investments.

The portfolio of companies which Temasek holds is shown in APPENDIX 1 (DIAGRAM A).

1.3 The pros and cons of a Temasek-style company

A Temasek-style company implies that an overarching investment holding company will be the parent company for all Indonesian SOEs. The parent company will centralize general services such as human resources, in-house skills training, finance, professional services etc.

1.3.1 The advantages of a holding company

The Temasek model's success is built on four key factors:

- The separation of the Government's roles as owner and shareholder from the roles of policy maker and regulator.
- Clear focus on value maximization. No non-commercial objectives.
- The SOEs in Temasek's portfolio operate independently as commercial entities with adherence to the highest standards of corporate governance resulting high level of disclosure.
- Temasek focuses on achieving sustainable, long-term shareholder value.

We envision similar benefits for the Indonesian SOE holding company.

The holding company will manage the SOEs on the behalf of the state
Placing the SOEs, which are currently under the BUMN, in a single holding company will allow the state to focus more intently on its role as a policymaker and regulator instead of being caught up in the operational duties of a shareholder. This would minimise and even eliminate the state's direct involvement in the day-to-day operations of the SOEs and avoid conflicts of interest from arising. Excessive meddling by the state may also hinder the effective functioning of these companies. The holding company will manage the government's assets in a professional manner, adopting a commercially disciplined approach to investments and managing the businesses under its charge. While the state can advise on the broad strategic direction, it will not be involved in the micromanaging of the subsidiaries.

The holding company will be able to focus on a long-term investment horizon
Since the holding company will be incorporated and solely owned by the state, it functions like any other private company with no need to disclose financial information to the public. Hence, the subsidiary SOEs can focus on unlocking and maximising long-term value instead of pandering to short-term shareholder demands which may fluctuate according to cyclicality. The ability to invest and nurture companies for the future is of paramount importance, since there are investments which will only pay off handsomely in the long run.

The holding company will provide coherent strategic direction
A coherent strategic direction under the aegis of the national strategy can be developed by the holding company and be adhered to by subsidiary firms. This will allow SOEs to be more in line with government policies and strive to attain national goals in a cohesive manner. Synchronization of policies to pursue the priorities set by the government will also be smoother. The holding company will serve as the headquarters for the group of Indonesian SOEs. State-owned companies held under the investment holding company will have greater clarity in terms of strategic direction and will be able to reinforce one another in various areas, creating a cohesive SOE ecosystem which will be beneficial to SOE growth and provide a fillip to the Indonesian economy due to the economic significance of the SOEs.

Synergies from economies of scale
In Indonesia, there exist SOEs that provide overlapping services in the same sector. Thus, there can be a merger of overlapping functions into a single SOE to prevent the wasteful duplication of services. Furthermore, with the consolidation of SOEs operating in the same sector into a single entity, economies of scale will be

enjoyed because of the increased economic scale of the combined entity. This means that at the same production level, the holding company will enjoy lower costs compared to the combined costs of the individual firms due to economies of scale. This is crucial in sectors which require high fixed costs, such as the oil and gas sector, the telecommunications sector, etc. In these sectors, the cost savings from reaping economies of scale could be substantial. Hence, scale economies will help to streamline costs in SOEs, spread overheads across a larger scale of operations and thus improve the competitiveness of Indonesian SOEs vis-à-vis the private sector and foreign companies. This will allow for more efficient and profitable operations.

Synergies from economies of scope

Economies of scope will also be enjoyed when the subsidiary firms come together and share best practices in operations and corporate governance, reducing costs through sharing centralized functions and improving efficiency through cross-selling of various energy products and services. The headquarters can coordinate shared services among the subsidiary SOEs which will translate into reduced costs as certain fixed costs are spread over a larger economic scale and certain centralized services are shared across firms. Also, the holding company can serve as a means for efficient capital allocation and help facilitate closer cooperation and possible joint ventures among the subsidiary companies. Furthermore, parking the SOEs under an overarching institution may lead to the creation of a positive ecosystem in which best practices are shared among the SOEs, leading to greater operational efficacy.

Training and technology will enjoy a boost

When there is sufficient economic scale, it makes sense to invest in a proprietary training institute for SOE executives to provide generic in-house skills training to groom talent. This will ensure that skill sets are of a consistent standard and serve as a pipeline for talent. In terms of technology, a dedicated R&D centre can assume the R&D responsibilities for the SOEs. This means that while sector-specific technological development will be taking place, there might also be the chance of cross-sector synergies appearing in a research project, allowing the new technology to be applied across a few sectors. Since R&D costs can be shared across the SOEs under the parent company, this makes technology development more cost-effective.

Larger scale and deeper pockets will facilitate easier entry into international markets

The aforementioned economic scale will also accord the holding company a prominent presence in international markets. An international foray is definitely more viable for larger companies compared to a small or medium enterprise. Larger companies will have deeper pockets and also greater clout to raise funds from financial markets. This means that when there are appropriate overseas opportunities to invest, the relevant Indonesian SOE can realize the opportunity as it has the backing of a large holding company with sufficient resources to fund international expansion.

Competitive forces will force SOEs to shape up or ship out

The transfer of Indonesian SOEs from under the wing of the Ministry of SOEs to a private holding company will expose SOEs to competitive market forces, as there is no implicit government guarantee of survival. Market forces and opportunities will guide the activities of Indonesian SOEs and not the agenda of policymakers. This will compel them to make the necessary gains in efficiency and productivity or risk being completely eliminated from the market. Furthermore, reducing the public sector footprint in the market also means that there is lesser crowding out of private sector activity and may result in a more vibrant investment and innovation environment in Indonesia.

1.3.2 The disadvantages of a holding company

Information opacity is unavoidable

Given that the holding company will be a private enterprise, this means that a certain level of opacity in information disclosure is unavoidable and even necessary so as not to give away any sensitive information about the size and dealings of the SOEs. Understandably, this could invoke unhappiness among citizens due to the lack of accountability on government-held assets. However, this disgruntlement could be dissipated if the holding company is well-managed and yields dividends for the government.

Diseconomies of scale may lead to added costs

A large organization such as an investment holding company with all of Indonesia's SOEs in its portfolio may be challenging to run. This is where choosing and grooming capable corporate leaders and granting autonomy to the subsidiaries in day-to-day operations is key. If it is well executed, the added layer which the holding company provides will not be an extra layer of bureaucracy but rather, a layer shielding the SOEs from politics and government intervention and thereby facilitating efficient and profitable operations.

1.4 Why Temasek Holdings is the model to follow

The success of Temasek Holdings is testament to the fact that advantages outweigh disadvantages in consolidating SOEs under a single holding company. This shows that on balance, an investment holding company can indeed add value to the firms in their portfolios through prudent management policies and by exploiting cross-firm synergies and contributing to the country's economic growth and societal well-being.

SECTION 2
Steps to Transform the BUMN

A state-owned enterprise (SOE) in Indonesia is defined as an enterprise whose capital is wholly owned by the State, or whose majority of shares (i.e. more than 51%) is owned by the state, which can be a joint venture between the state and local governments, the state and foreign companies, or the state and national private companies.

Currently, the Badan Usaha Milik Negara (BUMN) or the Ministry of State-owned Enterprises is in charge of managing Indonesia's 137 SOEs (as of 1 Jan 2014). These SOEs have combined assets of USD350bn and employ about 800,000 people[3]. Their revenues of USD155bn in 2013 constituted 18% of Indonesia's GDP. Thus, it is manifestly evidently that Indonesian SOEs dominate swathes of the domestic economy. These SOEs cover a range of industries and vary in size from large, national monopolies and public infrastructure enterprises to relatively small service companies.

The Ministry of SOEs is primarily in charge of policy formulation and implementation, as well as the synchronization of policies for the SOEs. Its main policy direction now is to conduct right-sizing, restructuring and revitalizing the SOE sector to achieve greater efficiency and profitability.

This paper seeks to promote the adoption of the Temasek model to rejuvenate the SOE sector in a coherent direction under competent management. The overarching plan is to consolidate virtually all of Indonesia's SOEs under the ownership of a single, well-run investment holding company. This will align the strate-

[3] As of October 2014

gic direction of the many SOEs, streamline bureaucratic processes, improve efficiency and unlock greater value in Indonesia's SOEs through unleashing inherent synergies.

The various phases that this transformation process should follow are listed below.

2.1 PHASE 1: Roadmap to transform the BUMN

Firstly and most importantly, the rationale behind the need for a revolutionary SOE reform must be well thought out and articulated in order to gain the political will to push through the entire process. A roadmap with a specific timeline must be formulated in order to provide transparency and clarity to the task at hand.

This roadmap ought to take into account the stakeholders involved, incorporating opinions and views from parties such as the parliament, BUMN's technocrats, and the general public. This roadmap should include detailed plans to formalize the creation of a private, commercial entity (the eventual holding company) to replace the BUMN as the "business manager" of all Indonesian SOEs, the consolidation of related SOEs into a single, larger-scale entity, and how value can be created for the Indonesian government.

To be effective in implementing the roadmap, a committee led by the Coordinating Minister of Economy will need to be appointed by the President. The members of the committee will include Minister of Finance, Technical Ministers of the business sectors, Indonesian Supreme Audit Institution etc. Each member, for the purpose of the discussion, will provide solutions to strategic decisions and may invite/solicit input and/or assistance from other government agencies or parties deemed necessary relating to sectorial issues. The Chairperson of the committee shall report to the President on three issues:

a. Time frame of the transformation program
b. Annual program roadmap
c. Implementation of the transformation program

Upon the approval of the roadmap by the President, the Minister of Finance will socialize to the public and consult with the House of Representatives. The Constitutional Court will make its final approval related to the Law Public Finance.

2.2 PHASE 2: Legislation to institutionalize the transformed role of the BUMN

Once the roadmap is established and the timeline of events made clear to all involved in the creation of a Temasek-style holding company for SOEs, there is a need for proper legislation to be passed in Parliament to institutionalize the transformed role of the BUMN from an SOE ministry to a private sector commercial vehicle with all SOEs in its portfolio. Furthermore, details such as the tax, commercial and legal implications of the holding company need to be clarified and codified in law as well.

This legislation will cement the role of the holding company and separate the role of the state from the management of the SOE holding company. However, similar to Temasek, the appointments of the Board of Directors of the parent company can be made by the government, considering strongly a ratio of 60% independent business professionals, but the boards of individual subsidiary firms will be appointed by the holding company's management, and based on merit. The government can also mandate that the chief executive of the SOE holding company report to the Minister for Finance annually, to brief government authorities on the financial health and performance of the holding company while receiving advice on future strategic direction.

There are two main legislative pathways potentially related to such a reform. The first would be a new Government Regulation (*peraturan pemerintah* or *PP*), which are specific laws designed and proposed by a minister within an executive agency and signed by the President. Secondly, Presidential Regulations (*peraturan presiden*, or *perpres*) are issued by the President. In addition, there are other potential tools in the policymaking toolbox, such as Presidential Instructions, Presidential Decrees, Ministerial Decrees, and Joint Ministerial Decrees.

The first key decision related to legislation relates to whether this reform would be proposed by the government or the DPR.[4] The relevant ministry, together with the Ministry of Law and Human Rights, would first draft the government bill. A small group would then be formed, including key decision-makers from the government as well as technical experts from NGOs and universities. The universities serve an important function, as they often provide the blueprint that includes legislation clauses, any caveats, limitations, etc. The Ministry of Law and Human Rights then would coordinate the final drafting of the law that government then would propose to parliament. Once the draft bill is completed, the coordinating ministry would review it, and it is then sent to the speakers and deputy speakers of the DPR for further discussion within the given ministry. It would then be sent to a steering committee that would identify the most appropriate commission to steward the legislation through the DPR process.

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[4] For an excellent discussion of the Indonesian policymaking process see *http://www.smeru.or.id/report/workpaper/politicaleconomy/politicaleconomy.pdf*, which outlines in more detail the summarized discussion in this section of the paper.

The government representatives championing the legislative change then must schedule a series of discussions with the relevant DPR commission, mentioned above. All interests and views of each party sub-group would be present and legally must be discussed publicly, to which various non-profit, civil society, and other organizations are invited, as well as business, government and other stakeholders. An inventory of problems is drafted (daftar inventarisasi masalah, or DIM) by the work committee appointed by the commission, which identifies difficult and contentious aspects of the proposed bill. This list may contain hundreds of items and forms the basis for negotiations between the government and DPR members. The post-negotiation bill is then sent back to the commission. Finally the bill is formally accepted and passed by a plenary session, then signed by the president. Formal responses to the positions of the party caucuses are also finalized by the government.

Should the bill be proposed by a DPR commission or legislation committee, it must enjoy the formal signed support of a minimum of 10 members. An expert taskforce would be convened, and recommendations are sent to the committee. After consensus is reached, the bill enters a plenary session for formal acceptance as a DPR initiative. The president signs the bill and assigns a minister to represent the government in any discussions. The bill then enters the first stage and from there on follows procedures outlined above for government sponsored bills.

A government regulation could also be contemplated, in which a ministry is identified to act as a sponsor to coordinate with other ministries. Again an academic report would then be commissioned, and a draft regulation drawn for people to debate. The bill is then finalized and sent to all related ministries for approval.

The final draft and approval letter is then sent to the State Secretariat, which coordinates all draft decrees and instructions issued by the government, for a cabinet-level discussion and then presidential signature. The State Gazette of the Republic of Indonesia (Lembaran Negara Republik Indonesia) then issues the regulation from the State Secretariat.

2.3 PHASE 3: Incorporation of the BUMN as a commercial entity

With the legislation in place, the transformation of the SOE ministry into a SOE holding company can be initiated. The incorporation of the new holding company and the subsequent transfer of SOE assets will be a drawn out process. The SOEs placed under the management of the SOE holding company will be categorized by key segments of the economy. In the transfer process, duplicated services by two or more SOEs will be consolidated into the larger entity to enhance its scale of operations.

The Ministry of Finance, with the inputs from the President, will appoint the Board of Directors for the parent company. Preferably, the directors will include technocrats and private sector leaders, along with senior and capable government officials. The crux is to inject professionalism into the leadership and thus allow the SOEs to operate with commercial interests as the main driver.

At the end of this phase, the BUMN will cease to exist as a government ministry and the resultant holding company will report directly to the Ministry of Finance, with the government as the sole shareholder of the company.

2.4 PHASE 4: Establishing fundamentals and fostering growth

In order to deliver tangible value to the Indonesian government and have a positive effect on the domestic economy, the SOE holding company will need to ensure that its subsidiaries are cognizant of its overall long-term strategic direction. Thus, the creation of a company charter – a set of core principles – to guide the actions of the company and its subsidiary SOEs will be necessary. This will also codify the values which are important to the parent company. There is also a need to institute standards of corporate governance, transparency, and market discipline.

When the holding company is progressing at a steady clip, there can be consideration on right-sizing the number of SOEs into a more manageable number, each with their core competencies which will benefit the Indonesian economy. For the more established SOEs, they can be tasked with expansion into international markets in order to grow and compete globally.

SECTION 3
Suggested structure of holding company for Indonesia

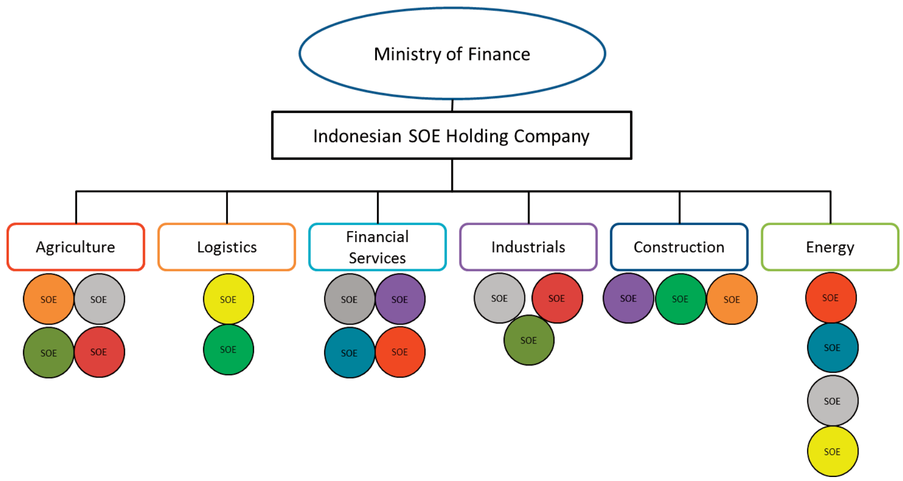
The holding company will be in charge of setting the broad strategic direction, in line with national policy, for the subsidiary SOEs. Economies of scale and scope are expected to be reaped, leading to a streamlined outfit equipped with greater competiveness and profitability. A more streamlined structure is also expected with the holding company acting as the HQ, coordinating shared services and overseeing corporate governance. With the grooming of capable personnel and increased focus on R&D, there is great potential in the benefits to be reaped from having a high-quality workforce to complement cutting edge technology. Furthermore, with more efficient capital allocation to investments in productive assets, Indonesia's energy SOEs can enter regional and international markets and become a regional leader in energy production.

The holding company for energy SOEs in Indonesia is proposed to be the majority shareholder in each of the subsidiary companies, in order to retain a good measure of control over company policies and strategic direction. It may also hold the power to appoint senior management, taking into account inputs from the Ministry of Finance and other relevant ministries and government agencies.

Individual SOEs are expected to function as commercial entities, with the bottom line an important part of performance evaluation. Profits and dividends by these subsidiaries will be collected by the holding company that will in turn pay an annual dividend to its sole shareholder, the Indonesian Ministry of Finance.

DIAGRAM 1

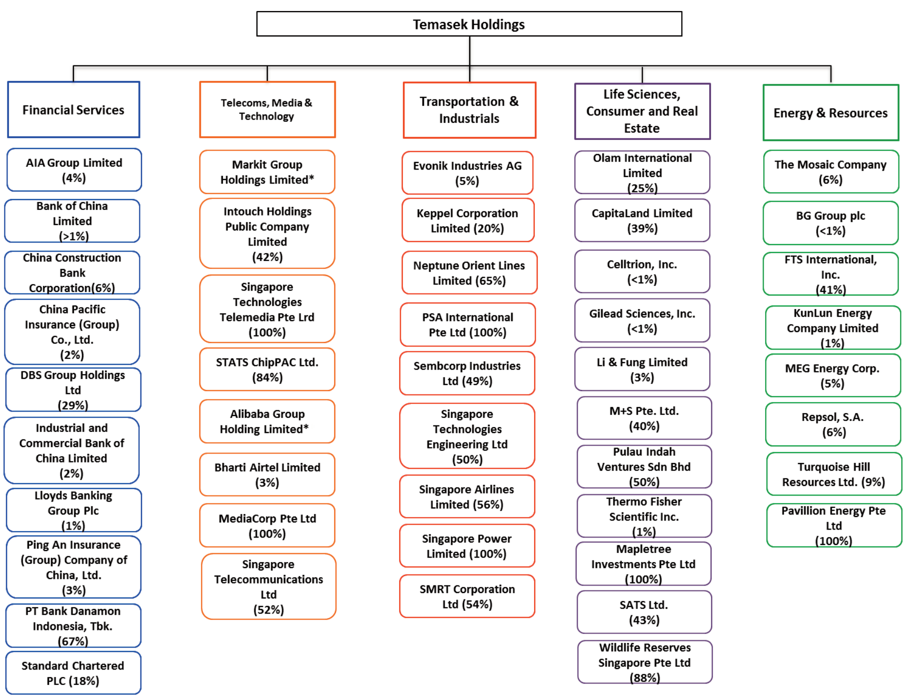
Suggested structure of the Temasek-style SOE holding company



APPENDIX 1
Organizational structure of Temasek Holdings

DIAGRAM A
The Portfolio of Temasek Holdings

Temasek Holdings separates its investments into major sectors of the economy in order to better manage these companies.



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