The Setting

On October 20, 2019, the recently re-elected Indonesian President Joko Widodo ("Jokowi") is expected to be inaugurated. Immediately after the inauguration, Jokowi is expected to announce his new cabinet. At the same time, the People's Representative Council, also known as the House, with 575 members will begin its 2019 to 2024 term.

Although Jokowi's re-election was positively received by the public and global financial markets, the five months since his victory have highlighted a number of fault lines related to religious, regional, and institutional challenges. In the past month, there have been significant street protests due to efforts by the outgoing House to restrict anti-corruption oversight and to impose religiously inspired laws imposing legal penalties for extra-marital affairs. Although these legislative initiatives have been put on hold, regional violence in Papua has also resulted in heightened domestic security tensions. The government reacted to these developments and the demonstrations by pointing to the risk of disruption by Islamic groups—a theory that some will feel was validated a knife attack on Wiranto, a high-profile military-linked cabinet minister on October 10th.

These political developments come at a sensitive time for Indonesia's economy. The country has benefitted from strong economic growth relative to its emerging market peers in recent years, with GDP growth trending in the 5% range on the back of strong domestic consumption and fixed capital investment. Sri Mulyani, the well-regarded Finance Minister, is given credit for returning Indonesia's sovereign credit to investment grade status in May 2017. This confidence was tested in 2018 when Indonesia successfully navigated a period of currency volatility. The banking sector is regarded as stable despite cyclical risks.

Indonesia's stable economic fundamentals have, however, permitted a number of risks to accumulate related to the governance of the energy sector that have the potential to be destabilizing for the economy and negative for climate outcomes. Over the past two years, through an extended pre-election period, new policies favoring resource nationalism have resulted in expansive new efforts to increase support for state-owned enterprises (SOEs) in the resource extraction and processing sectors. At the same time, the state-owned national power company, PLN has accelerated efforts to commission new coal-fired power capacity to support domestic coal producers. This effort has dovetailed with increasingly aggressive efforts by North Asian export credit agencies (ECAs) to back high carbon industrial and power projects in Indonesia to offset market share losses in more developed markets.

The focus on Indonesia as a high priority target market for its North Asian neighbors highlights Indonesia's dis-engaged posture on climate policies and energy transition. Although Indonesia has participated in global climate target-setting, and has an unconditional Nationally Determined Commitment to cut emissions by 29% by 2030, tangible policy progress on energy transition is notably weak. Compliance with the 2030 target is expected to rely heavily on land use related policies and ignores strong commitments to increase PLN's investment new coal-fired power capacity. The economy remains highly dependent upon exports of fossil fuels. Royalties and related revenue from energy exports account for roughly half of Indonesia's non-tax revenue.

The Catalyst

On October 20th, immediately after his inauguration, Jokowi announces his new cabinet. Instead of retaining or promoting Sri Mulyani, she has been appointed to an honorary oversight role that is divorced from policymaking. Insiders speculate that she will step away from government at the first opportunity. In the meantime, four critical roles—the SOE Minister, the Energy Minister, the head of PLN, and the coordinating Minister for Maritime Affairs—have been filled by individuals known to be closely aligned with well-connected resource sector interests, effectively ending checks and balances on resource nationalism.

The Aftermath

At first, market observers prevaricate. The ratings agencies and foreign investors adjust outlook ratings but not the core bond ratings that would trigger a downgrade of the sovereign bond rating. This neutral stance is aided by a belief that Indonesia may continue to perform better on a relative basis than its more fragile emerging market peers.

A new risk trigger emerges as developments at PLN make it clear that the company's operational and financial position is worse than previously understood and that it may be deteriorating rapidly. This has serious implications for Indonesia's fiscal position because PLN required a direct subsidy of USD5.0 billion in 2018 in order to stay aligned with the rating agencies' debt metrics needed to retain access to bond markets. Based on IEEFA's forecasts, this operating subsidy is expected to nearly double by 2021 as a series of new independent power projects (IPPs) come on line. Barring a renegotiation of PLN's power purchase agreements (PPAs) with international consortia, PLN will struggle to reduce its foreign currency funding obligations and will suffer from currency-linked fuel price volatility.

This encourages investors and analysts to increase their scrutiny of PLN. It becomes obvious that Jokowi's first-term focus on a 35GW growth target for PLN created significant incentives for corrupt practices related to non-transparent and high cost IPP approvals. An investigation by the Corruption Eradication Commission (KPK) uncovers billions of dollars of uneconomic fossil fuel deals recently approved by PLN including a high profile 2GW IPP involving a leading domestic resource company, Korea's export credit agency (KEXIM), Korea Electric Power Company, an arm of PLN, and a consortia of leading Asian banks.

As the focus on PLN's financial hole grows along with a better understanding of the scale of corruption involved, international equipment providers, domestic coal producers, banks, and project sponsors begin to exert political pressure for a bailout. In the meantime, the House pushes through new legislation which effectively shuts down KPK and reduces legal liability for any government officials or politicians in oversight roles. Rumors about the possibility of a military coup become common in a development reminiscent of 1997-1998.

As cash flow worries at PLN become more severe, new operational problems emerge. PLN loses public support due to the catastrophic blackout in August 2019 and the failure to address persistent customer complaints. To calm public anger, Jokowi pushes for a continuation of the tariff freeze that has been in place since early 2018. At the same time, the government is forced to address related corruption inquiries for other SOEs.

Financial Repercussions

Once it becomes clear that PLN's problems reflect a comprehensive governance failure that the Indonesian government cannot manage without serious financial aid, S&P and Moody's belatedly downgrade PLN, cutting the link to the sovereign credit. In addition, they move to negative outlook on the sovereign rating as well. This triggers a round of serious currency weakness that undermines Indonesia's growth outlook and exacerbates repayment risks for heavily exposed North Asian ECAs. Moreover, it effectively closes the bond market for PLN which needs to refinance outstanding FX maturities in early 2020.

Political jockeying between the Japanese, the Koreans, the Chinese and their Indonesian counter parties sets in. Limited offers of financial support for PLN are put on the table, but a lack of transparency about PLN's operational health damages the credibility of efforts to identify viable collateral. Many of PLN's older coal units on heavily populated Java effectively become stranded assets as newly commissioned IPPs with guaranteed capacity payments are commissioned in 2020. Price concessions are imposed on domestic coal suppliers to ease pressure on PLN and this move triggers consolidation and bankruptcies in the domestic coal sector with negative implications for the leading domestic banks.

There is an additional source of collateral damage. Slower economic growth and falling resource prices hurt the financial viability of a number of half-finished resource processing projects that were launched by domestic SOEs as part of the resource nationalism program. These assets are not yet financially viable and are placing added pressure on the country's fiscal buffers. Many are carbon-intensive projects and their financial viability rests on subsidized power from PLN.

In the meantime, analysts and Indonesian budget experts begin to examine the consequences of a PLN bankruptcy. This adds to political risks as it becomes clear that significant IDR PLN bond holders include many of the largest domestic pension funds, spreading exposure to Indonesia's middle and working class. The composition of PLN's USD bondholders shifts rapidly as experienced global distress debt players take significant positions, looking for ways to increase pressure on the Indonesian government to take explicit steps to support PLN.

One of the few ways to create a pathway to value for North Asian and global donors with growing clean energy equipment, EV, and battery industries could be to negotiate preferred market access in exchange for soft refinancing terms. Due to Indonesia's long history as a fossil fuel power market, the government lacks a seasoned pool of experts who can evaluate the issues and build trust within the government or with donors. This creates a high barrier for innovative solutions that could put a floor under PLN and create value for donors willing to provide support for a clean energy pathway. At the same time, the ECAs and the credit rating agencies struggle to bring new analytical strategies into the equation as well.