Future Flow/Indonesia
Presale Report

IndoCoal Exports (Cayman) Limited - Series 2005-1

Expected Rating*

Class	Amount (m)	Final Maturity	Rating	Note Type
A	USD[600]	[July 2012]	BBB-	Fixed

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* Expected ratings do not reflect final ratings and are based on information provided to Fitch as of May 2005. Final ratings are contingent on final documents conforming to information already received as well as the provision of satisfactory legal opinions. Ratings are not a recommendation to buy, sell or hold any security.

Summary

Fitch has assigned an expected rating to the Series 2005-1 notes ("the notes") to be issued by IndoCoal Exports (Cayman) Limited ("the issuer") as indicated at left. The expected rating addresses the likelihood that cash flows generated by the assigned receivables will be sufficient to ensure timely payment of interest and principal on the notes over the life of the transaction.

The transaction is a structured export note backed by receivables (both existing and future) generated from the businesses of PT Kaltim Prima Coal ("KPC") and PT Arutmin Indonesia ("Arutmin") (together, "the seller parties"). The seller parties, who are leading coal producers, jointly accounted for approximately 29% of Indonesian coal production in 2004. The seller parties are both subsidiaries of PT Bumi Resources Tbk ("Bumi") and each operates under a Coal Contracts of Work ("CCOW") granted by the government of Indonesia.

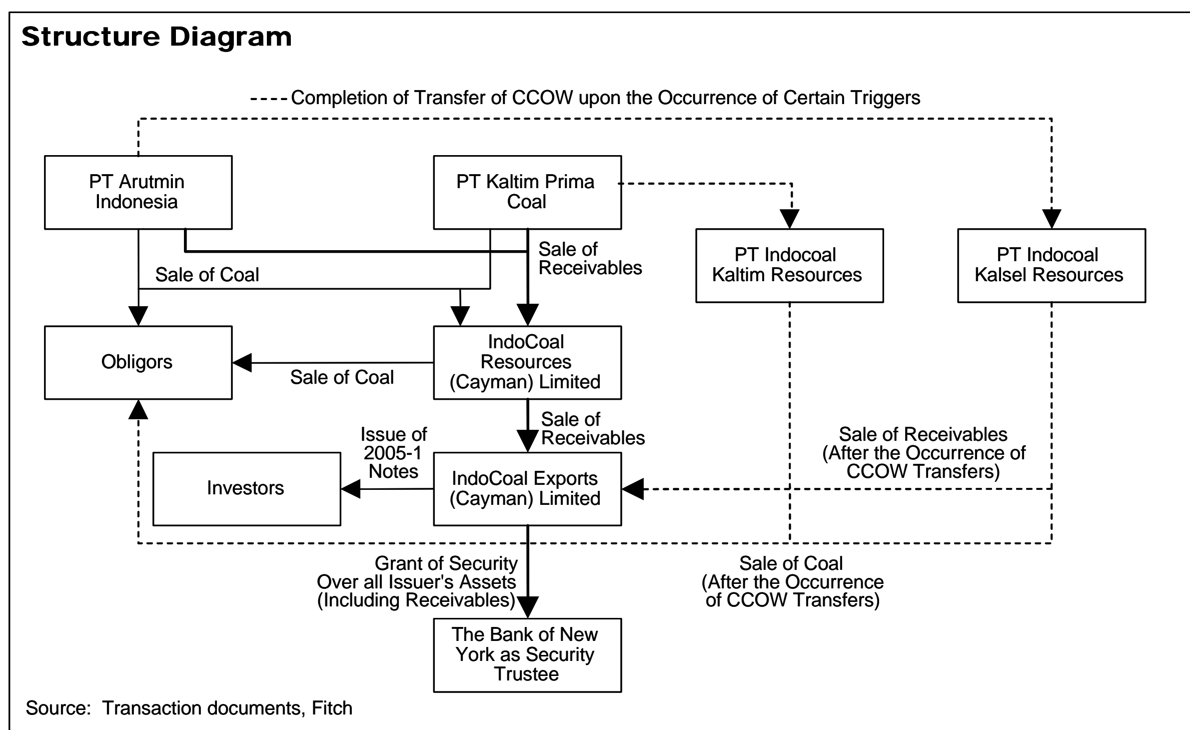
As a future flow transaction, the transaction relies on the ongoing production and export sale of coal even in the event of the bankruptcy or insolvency of either or both of the seller parties. Fitch assessed the transaction's ability to withstand an investment-grade stress using its going concern assessment ("GCA"), complemented by the incorporation of various structural features. The rating of the transaction is capped by the GCA of the combined entity. Any deterioration in the credit quality of KPC or Arutmin may affect the GCA and, by extension, the rating of the notes. The 'BBB-(BBB minus)' expected rating exceeds the 'BB-(BB minus)' Long-term sovereign rating of the Republic of Indonesia.

Fitch's GCA can be broadly described as an indication of an entity's ability to continue its operations in a particular line of business as a going concern, despite financial difficulties. For the purposes of this report, KPC and Arutmin will be treated as a single entity since the notes are supported by all the receivables generated by these two companies.

Strengths

Front-loaded amortisation schedule: The amortisation schedule for the notes is front-loaded to take advantage of strong demand and price environment for coal in the global market in the short to medium term. This structure mitigates the risk of greater uncertainty surrounding prices in the longer term; it also substantially mitigates refinancing risk.

Substantial coal reserves and strong demand for coal: The sellers have sufficient reserves to meet planned production over the life of the transaction, with a combined 959mt of proved and probable marketable reserves as of 31 March 2005. In Fitch's view, coal prices and coal demand in the Asia Pacific region are likely to remain robust over the medium term, driven by healthy economic growth, by the strength of oil and gas prices and by the rising number of coal-fired power plants in the region.



- **Reserve account:** a reserve account will be set up at closing, funded to the equivalent of three months' interest and principal payments. Within six months after closing, the reserve account is required to be funded with up to six months of interest and principal.

- **Transaction cash flows held in collection accounts:** All the underlying obligors for the transferred export receivables will be given notice and instructions to make their payments directly into collection accounts in New York. All disbursements from these accounts will be subject to verification by the transaction administrator. This arrangement mitigates the risk of a diversion of cash flows by any transaction parties as well as any commingling risk in the event of their bankruptcy.

- **No other creditors:** The seller parties covenant not to incur additional debt (contingent obligations, lease obligations or others) during the term of the transaction with the exception of obligations to trade creditors, payable within 180 days of their incurrence, and obligations under operating leases to finance capital expenditures. The issuer is prohibited from incurring any additional debt under the structured export note programme where such issuance would trigger an early amortisation event and would cause Fitch to withdraw its rating or downgrade the rating of the notes below the lower of the then-current rating and the 'BBB-(BBB minus)' expected rating assigned.

- **Diversified Operator Risk:** KPC and Arutmin contracts with four major contractors for its coal production, while KPC carries out its own mining operations. The diversification of relationship among several production contractors mitigates event risks specific to certain contractors.

- **Transaction monitoring by the transaction administrator:** The transaction administrator, an independent third party appointed by the indenture trustee, will provide auditing services to ensure compliance with the transaction documents. The duties of the transaction administrator include: comparing payments to marketing agents and contractors against invoices; verifying the cash flow waterfall; and obtaining consents from new marketing agents or contractors, if any, who are to be paid on a priority basis in accordance with the transaction documents.

- **Strong transaction cash flows:** Fitch's cash flow analysis incorporates several stresses, including price and volume stresses, under which the transaction is still capable of covering debt service.

- **Early amortisation triggers protect investors from deteriorating performance:** The transaction incorporates multiple early amortisation triggers that will serve as early warning mechanisms if the transaction deviates substantially from expectations at closing. The

triggers monitor the excess cash flows available, the amount of eligible receivables and production targets, among others.

Concerns

- **No notification to the government:** The government will only be notified of the transfer of the CCOWs on the occurrence of certain trigger events, but not prior to transaction closing. The risk of sovereign interference in the transaction, which is inherent to future flow transactions, takes the form of transfer and convertibility risks, nationalisation or expropriation risks, and redirection or diversion risks, in terms both of products and obligors.

- **Bankruptcy of the seller parties:** The bankruptcy or insolvency of KPC and/or Arutmin could affect their ability to generate receivables and, ultimately, cash flows for the transaction.

- **"Greenfield" nature of the Bengalon mine:** The Bengalon mine is a greenfield development that is expected to expand production at KPC substantially, producing approximately 10% of the seller parties' total production volumes for 2005, rising to approximately 27% in 2012. The associated risk is further exacerbated by issues related to PT Henry Walker Eltin Indonesia ("HWEI"), the production contractor for Bengalon and a former subsidiary of Henry Walker Eltin, which entered into voluntary administration in January 2005.

- **Production targets not met:** The failure of the production contractors to meet production targets that directly affect the ability to generate receivables and thus cash flows to the transaction.

- **Lumpy capex requirements:** Based on discussions with management and a report produced by Minarco Asia Pacific ("Minarco", see *Independent Technical Review*), Fitch notes that the seller parties have sizeable capex requirements, and a major portion of which is likely to be concentrated in 2006 and 2007. This could cause a shortfall in the cash flows required to service debt.

Mitigants

- **Clean legal opinion:** Fitch is advised that there is no legal requirement to notify the government of Indonesia of the transfer of the receivables at transaction closing. Only on the occurrence of certain transfer triggers, which will complete the transfer of the CCOW will it be necessary to notify the government. Furthermore, the economic incentives for the government to interfere are limited in Fitch's view. (For further description, see *Sovereign Risk* section).

- **Uninterrupted services by contractors and marketing agents:** Pursuant to the relevant security deeds, the seller parties will assign their rights under marketing services agreements and production contractor agreements such that the marketing agents and production contractors can continue to perform their duties, as stipulated in these agreements, in the event of the financial distress of the seller parties. The marketing agents and the contractors will have the incentive to continue performing since they are compensated on the basis of their performance. See *Stress Scenarios* section.

- **Bengalon forecast development achievable:** Fitch has examined the technical review performed by Minarco, which confirms that management's forecasts about the timing and the volume of production that the Bengalon mine will be able to deliver are achievable. However, to be conservative, Fitch has analysed in its stresses scenarios the impact of a one-year delay in Bengalon's planned output plus the capping of production at initial levels. See *Stress Scenarios* section.

- **Interests of the contractors aligned with those of the noteholders:** The production contractors are compensated on a per-tonne-produced basis and are strongly incentivised to meet their production targets. The transaction also incorporates an early amortisation trigger based on a test that requires the production levels of the seller parties to be at least 70% of the budgeted levels for any six consecutive calendar months. Failure to meet this test will constitute an early amortisation event.

- **Conservative cash flow analysis:** The capex disbursements are structured such that they will be expended only after debt service has been covered. However, to stress the cash flows in recognition of the fact that certain of these infrastructure expenditures are required to achieve higher production volumes, Fitch's cash flow analysis assumes that such capex amounts will be spent prior to payment of debt service.

Parties to the Transaction

Issuer: IndoCoal Exports (Cayman) Limited, a newly formed special-purpose company incorporated in the Cayman Islands whose issued shares are held on trust for a charitable entity and whose main activities are limited to issuing the notes, which will issue the subordinated notes to be held by the originator SPV and enter into a sale agreement with the originator SPV.

Seller Parties: PT Kaltim Prima Coal and PT Arutmin Indonesia.

Servicers: KPC and Arutmin

Indo SPVs: PT Indocoal Kaltim Resources ("KPC Indo SPV") and PT Indocoal Kalsel Resources ("Arutmin Indo SPV"), each a newly formed special-purpose company organised under the laws of the Republic of Indonesia; all but one of the shares of each are owned by Bumi.

Originator SPV: IndoCoal Resources (Cayman) Limited ("the originator SPV"), a newly formed special-purpose company incorporated in the Cayman Islands that is wholly owned by Bumi and whose main activities are limited to entering into long-term coal supply contracts, selling coal to obligors, entering into a receivables sale agreement with the seller parties, selling receivables to the issuer, and distributing dividends to Bumi.

Structuring Advisor: Merrill Lynch, Pierce, Fenner & Smith Inc.

Initial Purchasers: Merrill Lynch, Pierce, Fenner & Smith Inc. and P.T. Danatama Makmur

Transaction Administrator Trustee: Foo Kon Tan Grant Thornton, a member of Grant Thornton International, provides audit, accounting and financial services to its clients. The transaction administrator plays an integral role in the transaction, monitoring the compliance of the seller parties and servicers with the transaction documents.

Indenture and Security Trustee: Bank of New York ('AA-(AA minus)/F1+')

Transaction Highlights

Note Type: Fixed rate, monthly pay

Security: The security trustee will be granted security over all receivables and all assets of the seller parties and the Indo SPVs including, among others, a fiduciary transfer of proprietary rights, a fiduciary assignment of receivables, security deeds with respect to its rights under the marketing services agreements and production contractor agreements.

Amortisation: Mortgage style – 60% of principal amortised over the first three years and 40% amortised over the remaining four years.

Final Payment Date: Seven years

Transaction Summary

The transaction is a securitisation of all receivables generated by the sale of coal produced by mines operated by KPC and Arutmin, each of which operates under a CCOW granted by the government of Indonesia.

At transaction closing, the seller parties will transfer their respective rights and responsibilities under the CCOW pursuant to a deed of transfer to two newly established SPVs incorporated in Indonesia, PT Indocoal Kaltim ("KPV Indo SPV") and PT Indocoal Kalsel Resources ("Arutmin Indo SPV"). Both the Indonesian SPVs were set up by and are wholly owned subsidiaries of Bumi. The transfer of the CCOWs will be completed on the occurrence of certain transfer triggers.

Each of the seller parties will enter into a long-term coal supply contract with a third SPV whose seven-year duration will match the legal maturity of the transaction. The third SPV, IndoCoal Resources (Cayman) Ltd ("the originator SPV"), incorporated in the Cayman Islands, was set up by and is a wholly owned subsidiary of Bumi. The originator SPV will sell the coal it purchases from the seller parties directly to obligors and will purchase any receivables that exist at closing from the seller parties.

The originator SPV will further on-sell the receivables generated by the seller parties to the issuer, together with all receivables that it generates in the future. The issuer is an SPV incorporated in the Cayman Islands, whose shares are held by a charitable trust.

To fund the purchase of the existing and future receivables, the issuer will issue USD600 million in notes to capital market investors.

Rating Methodology

When analysing future flow transactions, Fitch seeks to answer three fundamental questions: what is the company's capacity to continue producing and selling its goods? How does the transaction structure protect against certain sovereign risks and other risks that might otherwise impair performance? And will the transaction generate sufficient cash flow under stress to pay noteholders in a timely manner?

Fitch finds the answers to these questions by examining the company, the obligors of the receivables and the risk of sovereign interference. It also evaluates the financial and legal structures of the transaction, and models cash flows to determine whether timely payment can be expected under given stress scenarios (for more information on Fitch's approach, see *"Future Flow Securitization Rating*

Methodology" dated 27 May 2003 and available on Fitch's website at www.fitchratings.com*).*

The structure follows the familiar pattern of other future flow securitisations. Sales to export customers are directed to offshore accounts, isolating the cash flow from any sovereign actions that could otherwise impede access to foreign currency. This mechanism allows Fitch to assign the transaction an expected rating above that of the sovereign. Unlike traditional asset-backed securities, future flow investors buy securities that depend on the generation of future receivables; therefore, the rating of the transaction is dependent on the capacity to produce and sell the relevant products – coal in this case.

■ Seller/Servicer Background

The transaction involves the securitisation of the receivables of KPC and Arutmin, both of which operate under production-sharing agreements with the Indonesian government known as CCOWs. The issuance proceeds will be used primarily to refinance debt incurred for the acquisition of the two entities by Bumi in 2003 and 2001, respectively. Key background information and related issues are discussed below.

PT Arutmin Indonesia

Arutmin was established in Indonesia on 31 October 1981 as a joint venture between Atlantic Richfield Company and Utah Exploration for the purpose of developing coal deposits in south-east Kalimantan. BHP Billiton ("BHP") acquired a 100% stake in the company, 50% in 1983 and 50% in 1986. Arutmin's concession extends to 2019 and covers a 70,153 hectare area. As of 31 March 2005, Arutmin had 391 employees, eight of whom are expatriates.

Production commenced at Arutmin's Senakin Mine in 1988 and at its Satui Mine in 1990. The two mines ramped up to commercial output levels following the completion of Arutmin's two coal preparation plants in 1991 and 1992 and the completion of its main coal terminal (North Pulau Laut Coal Terminal) in 1994.

PT Thiess Indonesia ("Thiess", see *Production Contractors*) was contracted in 1986-1997 to construct key plant and infrastructure for Arutmin and to operate the company's mines. The contract ended in February 1997, when the mines' output ramped up to stable commercial levels.

Under its CCOW, BHP was required to divest 51% of its interest in Arutmin to Indonesian parties within 10 years after the commencement of Arutmin's operations. In 1989, BHP divested 20% of its interests to PT Bakrie & Brothers Tbk ("Bakrie") and in 2001 it opted to divest the remaining 80%. BHP re-engaged Thiess to undertake Arutmin's operations on 12 June 2000.

On 23 October 2001, Bumi won the bid for Arutmin[1]. It financed the USD148m acquisition using loans from Bank Mandiri (USD103.9m) and PT Rifan Financindo Asset Management (USD45.2m), both of which were novated from Bumi to Arutmin following the acquisition.

Kaltim Prima Coal

KPC was established in April 1982 as a 50:50 joint venture between BP and Rio Tinto after the two were awarded a government concession to develop coal deposits along the coast of East Kalimantan. KPC's concession extends to 2021 and covers a 90,960-hectare area. As of 31 March 2005, KPC had 3,068 employees, 31 of whom are expatriates.

KPC began constructing its main mine, the Sangatta mine in January 1989. This was followed by the completion of large-scale mine development projects in 1991 and the commencement of commercial production in 1992.

As with Arutmin, BP and Rio Tinto were required by their CCOW to divest at least 51% of their collective interest in KPC to Indonesian parties between the fifth and the tenth years of KPC's operation. Although BP and Rio Tinto offered KPC for sale every year between 1996 and 2002, no sale was concluded until July 2003, when the two agreed to sell 100% of KPC to Bumi for USD480m.

BP and Rio Tinto did not retain minority interests in KPC as BP had exited the mining business, having divested all its mining assets except for KPC, while Rio Tinto (like BHP) prefers fully owned mines and generally avoids minority holdings.

The sale was completed on 10 October 2003. Bumi financed the transaction by directing KPC to take on USD404m of debt, of which USD186m was used to repay KPC's outstanding debt and USD218m was lent to Bumi for the acquisition. Bumi raised the remaining USD76m in the form of an inter-company loan from Arutmin, which raised debt in an equal amount.

Following the acquisition (on 13 October 2005) Bumi entered a share sale and purchase agreement with the local government (the East Kutai Regency Government, "EKRG") to sell 18.6% of KPC for USD104mn, with the rights to repurchase 10.6% back for the same price (the sale has yet to be executed). Later in March 2005, Bumi entered into an agreement

[1] Bumi completed the acquisition of 80% of Arutmin in November 2001 and it acquired the remaining 20% in August 2004 from a holding vehicle controlled by Bakrie's creditors (the vehicle was set up as part of Bakrie's debt restructuring).

to sell 32.4% of KPC to PT Sitrade Nusa Globus ("SNG", representing a group of private Indonesian investors)[2] for USD400mn. Should these sales be executed, Bumi could maintain majority ownership in KPC by exercising its 10.6% repurchase rights[3].

Bumi Resources

Founded in 1973, Bumi was established as Bumi Modern Tbk., an Indonesian investment company engaged in hotel and tourism, whose operations included the Hyatt Regency Hotel, an apartment complex in Surabaya and Le Meridien Hotel Tashkent in Uzbekistan. Bumi had been listed on the Jakarta stock exchange since 30 July 1990 (Ticker: BUMI).

In August 1997, PT Bakrie Capital acquired a 58.5% stake in Bumi, and in November, Bumi raised IDR108bn from a second offering. Bumi changed direction later that year by acquiring Gallo Oil (Jersey) Ltd. in December, while announcing plans to become a diversified natural resource company.

Gallo owns two oil concessions in Yemen: 50% of Block R-2 at East Al Maber (2,856km^2) and 100% of Block 13 at Al Armah (7,417km^2). The fields are currently in the early stages of exploration.

Following its name change in 2000, Bumi made the full transition to an energy company in 2001 by acquiring Arutmin in October and divesting its last hotel asset (Le Meridien, Tashkent) in November of the same year. Arutmin served as Bumi's sole revenue-generating asset until Bumi acquired KPC in 2003. Later in the same year, Bumi established Enercorp Ltd. (a 60% subsidiary) to serve as Arutmin's domestic sales agent.

Bumi is 57.17% owned by public and institutional investors, while the remaining interest is owned by entities controlled by the Bakrie family[4].

Post-Acquisition Transition

Although the sale of Arutmin and KPC to Bumi represented a change of ownership to a non-industry parent, Bumi was able to retain the companies' existing management teams, which consist of senior personnel trained by BHP and Rio Tinto. Mid-level management members – who are mainly locally recruited and trained staff – have also remained in place, as have the internal systems, controls and practices of KPC and Arutmin (which are in line with international standards).

In light of the factors above, the capacity of KPC and Arutmin to produce and sell coal, and to recruit and develop skilled managers have not been materially impaired by the change in ownership. Fitch expects the companies to maintain these capabilities for the life of the transaction.

■ The Going Concern Assessment

KPC and Arutmin's capacity to continue to produce and sell coal, and generate expected cash flows in stressed scenarios (even following a general default) is imperative to the performance of the notes and constitutes the basis of Fitch's GCA.

Specifically, the GCA considers the strengths and weaknesses of the relevant entities with respect to the production, sales and delivery of coal, with particular emphasis on the operating, corporate and market risks which could threaten the entities' cash flows. The GCA benefits from a number of structural features of the transaction, namely the combining of the sellers' strengths and the mitigation of key corporate risks. As the transaction relies on the cash flows of the relevant entities, the transaction rating is capped by the outcome of the GCA.

The "Synthetic" Entity, KPCA

The GCA for the transactions considers KPC and Arutmin as a combined entity, since 100% of the receivables of both entities are wrapped into the transaction under a single structure. The combination of the two expands scale, product diversity and market influence, and reduces risks relating to asset concentration.

Analytically, the combined entity is treated as the economic equivalent of a merged KPC and Arutmin (referred to from time to time as "KPCA" in this report), which is analysed and stressed as a single entity in Fitch's cash flow and coverage analysis. Accordingly, KPCA's GCA is the relevant output and serves as the rating ceiling for the transaction.

Reserves

KPC and Arutmin have sufficient reserves to meet planned production over the life of the transaction (2005-2012). As of 31 March 2005, KPC had 601mt of proved and probable marketable reserves while Arutmin had 358mt of proved and probable marketable reserves[5]. All reserve statements were

[2] According to Bumi, these sales were motivated by the CCOW's requirement to divest 51% of KPC to Indonesian parties (Bumi acquired KPC by acquiring BP's and Rio Tinto's offshore holding vehicles, which may not qualify as "Indonesian.").

[3] Bumi expects to lend EKRG the USD104mn, which would result in a cashless sale that provides Bumi the right to call 10.6% of KPC at any time (to be paid for by the cancellation of EKRG's USD104mn debt to Bumi).

[4] Long Haul Holdings (42.24%), Minarak Labuan Co. Ltd. (0.32%) and PT Bakrie Capital Indonesia (0.19%).

[5] As of 31 March 2005, KPC had 616mt of proved and probable recoverable reserves while Arutmin had 375mt of proved and probable recoverable reserves.

prepared by reputable, competent third parties in accordance with the JORC Code.

The reserves of KPC and Arutmin are supported by much larger resources, which, given ongoing exploration and drilling activities, should further contribute to the companies' reserve base, extend the mines' reserve lives and provide a substantial excess reserve buffer for the life of the transaction.

Production

Together, KPC and Arutmin is the largest producer and exporter of coal in Indonesia, accounting for some 29% of the country's production in 2004. From 36mt in 2004 (21.4mt KPC, 15mt Arutmin), KPCA plans to ramp up output to 50mt this year (32.2mt KPC, 18mt Arutmin) and to substantially higher levels in the next two to three years. When considering the feasibility of these planned volumes, Fitch drew comfort from the following factors:

- The technical feasibility of key expansion projects as well as the capacity of KPC and its contractors to plan, manage and execute existing and future projects are largely affirmed by the independent technical review ("ITR", see *Independent Technical Review).*

- The existing production capacity (which will produce a large share of planned volumes) is supported by management and production infrastructure that are in line with global standards and industry best practices, and have been in place and operating for over a decade.

- The expansion of existing mines accounts for a significant share of the planned expansion. These projects benefit from current infrastructure (pits, roads, coal chains, ports etc.), which substantially limit execution risks.

- Development of the greenfield Bengalon Mine is well under way. Since May 2005, Bengalon had been conveying coal from its mining pit to its barge loading facility. While delays caused by events relating to the contractor had reduced 2005's target volumes to 3.1mt from 6mt, such issues have been resolved recently (see below) and are unlikely to recur.

- Further expansion of Bengalon during 2006 and 2007 is achievable, in Minarco's view, and, given foreseeable execution risks, appears credible in Fitch's opinion. Presently, plant and infrastructure (coal haul road, crushing plant and barge loading facilities) with 6mtpa-10mtpa of capacity is on schedule for completion in 3Q05, which should allow Bengalon to ramp up output largely as planned.

Production Contractors

Roughly three-quarters of KPCA's output will be produced by contractors while one-quarter will be produced by KPC itself. In Fitch's view, KPC is competent and experienced in operating its own sites and is capable of producing its share of planned output. The reliability of the remaining volumes is dependent on the operating strength of the contractors and their commitment to executing on their contracts in a timely and satisfactory fashion.

Analysis of the relevant plans and credentials supports Fitch's view that the contractors are largely competent and capable of meeting the obligations of their production contracts, although more (but acceptable) risks are associated with HWEI owing to recent events (see below).

In general, the contractors are experienced in Indonesia and are familiar with local geology and terrain. KPC and Arutmin management have a long history of working with contractors and are skilled in managing and supervising their work.

These strengths are supplemented by well-established internal systems and controls, many of which are codified in the contractors' operating agreements. The contracts are robust documents that specify the responsibilities and liabilities of the parties and provide for the timely replacement of contractors should any fail to perform.

Consultation, planning and progress evaluation are conducted with the contractors on a weekly, monthly, quarterly and annual basis. The contractors' interests are long term in nature and are largely aligned with those of KPC and Arutmin, which are among their largest clients in the country. The contracts require a total of some USD450m in capital investments by the contractors, which further links their interests to the success of their respective projects.

The stability of the Bengalon contractor, HWEI, came into question at end-2004 when Henry Walker Eltin ("HWE"), HWEI's parent, filed for voluntary administration in Australia as a result of severe contract losses in that market. To secure the stability of the contract and the delivery of associated equipment, Bumi organized the purchase of HWE's interests in HWEI by a consortium of private investors (in May 2005).

HWEI's set-up is similar to those of BHP and BP/Rio Tinto prior to the sales of KPC and Arutmin. Its senior management was trained by HWE, and it is supported by an established local management

Independent Technical Review

From time to time, Fitch relies on expert third-party assessors to opine on the technical feasibility of greenfield projects in project finance transactions.

KPCA differs from greenfield project finance cases in that existing production and sales infrastructure of its mines have been in place and operating for over a decade and carry substantially less execution risk than those of greenfield projects. That said, Fitch points out that the transaction (and KPCA's GCA) relies on a significant ramp-up in output volumes over the life of the transaction, much of which is to be produced by a greenfield mine (Bengalon).

When assessing the feasibility of the ramp-up, Fitch considered opinions presented in an ITR prepared by Minarco Asia Pacific, a leading independent consultancy that provides resource evaluation, mining engineering, mine valuation and coal market analysis to natural resource and financial services firms. The review focuses on Bengalon and other expansion projects of KPC, which together account for 94% of KPCA's planned increase. Key findings of the ITR are presented below.

- **Reserves:** Points of observation such as drill holes, outcrops and the geological mapping of open-cut pits provided an adequate level of confidence about seam continuity, structure, thickness, coal quality and density to support reliable assessments of mining reserves.
- **Planning:** Forecasts are based on adequate and reliable geological and geotechnical data, taking proper account of mining conditions. The mine plans are well founded in terms of development and construction schedules, forecast production levels, yields, operating and capital costs. Minarco is satisfied that the production forecasts are achievable.
- **Mine Management:** The mines and projects are well managed by effective and capable management teams, sound development strategies and processes, as well as competent contractors with credible mine operation plans that address key technical risks. Regular internal and external audits are performed to identify any necessary improvements in safety and operations.
- **Health, Safety and Environment:** Management views risk-managed development and operations as highly important and occupational health and safety programmes are in place at each site. Environmental issues are well managed, with no known issues that could significantly impede production. Sufficient resources are allocated to address these issues.
- **Equipment:** The coal pit operators use well-maintained, modern mining equipment and technology, and employ mining methods typical for and suited to the targeted resources. Equipment either in place or planned in the capital forecasts is suited to the mine plans and supports the production forecasts.
- **Production ramp-up:** The expansion of KPC's existing mines (Sangatta) represents a ramping up of existing operations based on demonstrated competent mining practice for over 10 years, while Bengalon is a greenfield development and is therefore more exposed to start-up delays, lower mining efficiency and coal quality variances in the initial period.
- **Product:** Product quality is at the top of each category of coal, except for Bengalon coal, which has higher sulphur than is typical for power station coal. However, KPC is targeting markets less focused on sulphur for Bengalon, and it plans to reduce Bengalon coal's sulphur content via blending. KPC's projected sales targets can be met within these marketing strategy parameters.

Source: Minarco Asia Pacific, Fitch.

structure whose members were recruited and developed locally. As the management structure of HWEI is expected to remain largely intact, its ability to execute on the existing contract should not be materially impaired.

While above events delayed Bengalon's initial ramp up, the delay was one-time in nature and has not significantly impacted the progress of the mine's development (see *Production*). Equipment required to meet Bengalon's 2005 targets is either on site or en route, and should allow for the achievement of the revised planned volumes (3.1mt) this year. As for further capex needs over the duration of the contract, financing has been arranged with the help of Bumi.

Production Contractors

KPCA relies on contractors to produce roughly three-quarters of its planned output. The contractors charge on a per-tonne basis in accordance with stipulated strip ratios for the relevant mines. They are responsible for providing substantially all of the equipment, facilities, services, materials, supplies, labour and management required to produce the contracted volumes. The strengths of the contractors are key rating factors in Fitch's GCA for KPCA, as are the contractors' commitment to executing on their contracts in a timely and satisfactory fashion. Details of the contractors and their contracts are presented below.

- **PT Thiess Indonesia:** Thiess is a subsidiary of Thiess Pty Ltd, one of Australia's largest construction and engineering firms. Thiess is one of the largest mining contractors in Indonesia, with a long history of operating the mines of KPC and Artumin. Thiess has a 12-year contract with KPC and a life-of-mine contract with Arutmin to produce over 40% of KPCA's planned output to 2012.
- **PT Pamapersada Nusantara ("Pama"):** Pama is a subsidiary of United Tractors and it is the largest Indonesian mining contractor. Pama has a 10-year contract with KPC to produce roughly 10% of KPCA's planned output to 2012.
- **PT Cipta Kridatama ("CK"):** CK is a subsidiary of Trakindo Utama, a major Indonesian supplier of heavy equipment. CK is currently negotiating a new five-year contract with Arumin with the aim of producing some 3% of KPCA's output to 2012.
- **PT Henry Walker Eltin Indonesia:** Formerly Darma Henwa Indonesia, HWEI was a subsidiary of Henry Walker Eltin prior to HWE's voluntary administration at the end of 2004, which resulted in the sale of HWEI to a group of private investors coordinated by Bumi. HWEI has a 10-year contract with KPC to develop the Bengalon mine and to produce roughly one- fifth of KPCA's planned output to 2012.

HWEI will be subject to close supervision by KPC[6] in the future, as Bengalon is key to KPC's planned output expansion and the contract will generate nearly all of HWEI's income. In Fitch's view, these shared interests align the interests of HWEI's shareholders and management with those of KPC, and it is notable that KPC ultimately has the ability to replace HWEI if it fails to perform.

Product Risks

The products of KPC and Arutmin are well established within the region and are confirmed to be high in quality for their respective product categories (see *Independent Technical Review*). As coal is not a homogeneous product, new suppliers are required to undergo tender, product evaluation and QA processes. This discourages active supplier switching and benefits established coal suppliers.

The diversity of operating pits and seams, complemented by advanced blending capabilities, provides KPC and Arutmin with substantial flexibility to meet a wide range of product specifications. Historically, the two have consistently met contract specifications, thanks to rigorous quality control and close co-ordination with the offtakers.

[6] Notably, KPC's GM of mining development has been appointed the managing director of HWEI, while KPC's manager for Bengalon has been appointed the GM of operations for HWEI.

Although Bengalon coal is a new product and has relatively higher sulphur content, it has gained initial market acceptance with a number of coal marketers and power plants in the region (e.g. PT Freeport Indonesia and Taiwan Power Co.), with total contracted tonnage of 2.2mt as at 21 May 2005. KPC's plans to reduce the sulphur content of Bengalon coal (via blending) and to target less sulphur-focused markets should further ensure market development and future sales. The feasibility of related plans and targets has been largely affirmed by Minarco in its ITR (see *Independent Technical Review*), which provides further comfort to Fitch in its assessment of the Bengalon expansion.

Off-Take and Volume Risks

The customers of KPC and Arutmin are typically large utilities companies or industrial users of coal in Japan, Taiwan and other higher-rated jurisdictions in Asia. Most major clients have had long-standing relationships with the companies, which have remained stable following the change of ownership to Bumi.

Counterparty risks are well managed owing to the relatively strong credit profiles of key off-takers. Most of the coal produced by Arutmin and KPC is sold under long-term contracts of one to three years. Contract sales account for 70%-80% of the sales of KPC and Arutmin while the remainder is sold on the spot market. To limit risks associated with spot sales, this transaction requires that 70% of collections

Product Specification

	Prima	Pinang	Melawan	Bengalon	Senakin	Satui	Ecocoal	Batulicin
Calorific Value (kcal/kg)	7,100	6,290	5,690	6,230	6,700	6,800	5,000	6,600
Total Moisture (%)	10.5	17.0	23.0	19.0	11.0	10.0	35.0	9.0
Inherent Moisture (%)	5.0	13.0	18.0	14.0	6.0	6.0	23.0	4.5
Ash (%)	4.0	3.5	2.5	4.5	12.0	8.0	3.9	12.0
Volatile Matter (%)	39.2	39.0	38.5	40.0	44.3	41.5	38.0	43.0
Fixed Carbon (%)	52.0	44.5	41.0	41.5	40.2	43.5	35.1	40.5

Source: KPC, Arutmin, Fitch

(from export receivables) to be from sales under long-term contracts (see *Spot Market Exposure*).

Although off-take volumes are specified in contracts, sales are not guaranteed by "take-or-pay" provisions (in line with industry practice). While shipments could be rejected for failure to meet specifications, such events are rare and are quickly cured by a substitute shipment, with no impact on total contracted volumes or the stability of the overall contract. Generally, buyers rely on the coal produced by KPC and Arutmin for their core operations and prefer to maintain stable supply flows to avoid disruptions to operations. In practice, budgeted off-take closely matches actual deliveries, as close co-ordination is generally maintained with the off-takers.

Pricing and Price Risks

The sales contracts of KPC and Arutmin typically contain annual price resets. Pricing formulas vary from contract to contract – most referencing one or more industry price index [7], while some are additionally indexed to the US CPI. Contract pricing has a smoothing and lagged impact on prices, which protects against the high price volatility often observed in the spot market.

In Fitch's view, coal prices and coal demand in the Asia Pacific region are likely to remain robust over the next two to three years. The continuing strength of oil and gas prices has driven an increasing number of power utilities in the region to construct coal-fired power plants. This adds structural (non-transitory) demand for coal on top of strengthening secular demand driven by healthy economic growth in the region. These conditions benefit KPC, Arutmin and other regional coal exporters, because the coal markets are largely regional in nature (inter-regional sales are less economical owing to long-haul transport costs), and because exports by key coal producers in the region, (i.e. China and India) have been challenged by domestic coal shortfalls.

Noting that price risks may materialise as current conditions ease, Fitch has analysed the transaction's ability to perform under appropriate price stresses (see *Stress Scenarios*) and it has reviewed how related risks are addressed by the transaction structure (see *Coal Price Risks*).

Sales and Marketing

The sales of KPC and Arutmin were handled by Rio Tinto and BHP prior to their sale to Bumi. Following the change in ownership, Arutmin engaged BHP and Enercorp as its international and domestic sales agents, respectively, while KPC engaged Glencore International AG for international sales and Mitsubishi for sales to Japan. These marketing agents are largely strong, reputable and well-recognised international players with established sales channels and robust market positions. The marketing contractors and their contracts are described below:

- **Glencore:** Glencore International AG is a diversified natural resources conglomerate with activities in mining, smelting, refining and processing. It is a leader in commodities trading and has substantial experience in coal marketing in Asia. Glencore has a 12-year exclusive contract with KPC (signed in 2003) for all international markets except Japan with a commission rate of 5% of gross sales.

- **Mitsubishi:** Mitsubishi Corporation is the largest trading company in Japan and one of the largest coal traders in the country. It has a 12-year contract (signed in 2004) with KPC for all sales in Japan, with a commission rate of 5% of gross sales.

- **BHP:** BHP Billiton has an eight-year contract with Arutmin (signed in 2003) for all international sales, at a commission rate of 4% of gross sales

- **Enercorp:** Enercorp Ltd. is an energy commodity trading company that is 60% owned by Bumi (see *Bumi Resources*). It has a five-year contract with Arutmin (signed in 2002) for all domestic sales, at a commission rate of 4% of gross sales.

[7] E.g. JPU (Japanese Power Utilities) Reference Price or BJI (Barlow Jonker Index).

Sovereign Risks

Transfer and Convertibility

The transaction is not threatened by transfer and convertibility risk as the structure captures the seller parties' export receivables, which are denominated in USD and are collected offshore Indonesia. Moreover, export obligors will be given notice and instructions to pay their invoices directly into collection accounts in New York and held in the name of the trustee. The imposition of exchange controls is unlikely to affect the transaction since the USD cash flows are captured offshore and will pay debt service before funds are remitted to Indonesia.

Nationalisation and Expropriation

The incentives for the sovereign to nationalise or expropriate the mining assets are limited as it is receiving royalty payments equivalent to approximately 13.5% of the coal revenues. Based on the management's numbers, this amounts to approximately USD300m per annum for the life of the transaction. Furthermore, the CCOWs have performed unhindered for 23 and 24 years, for KPC and Arutmin, respectively, even during times of considerable political and economic turmoil.

Diversion and Redirection Risk

Fitch has considered the risk that the sovereign may interfere with: (i) the payments from the obligors by redirecting their payments into Indonesia; and (ii) product/customer redirection/diversion by directing the product to obligors outside the structure.

Payment redirection/diversion risk is mitigated by the fact that the export obligors will be given notice and instructions to pay to the collection accounts in New York. Product/customer redirection/diversion is mitigated by the fact that the operation is not state-owned and the mining operations are protected under the CCOW.

The transaction documents will require export obligors to be notified of the assignment of the receivables and to be given an irrevocable instruction to pay all due amounts into relevant collection accounts (see section entitled *Legal Review – Notice and Acknowledgement*).

The sovereign receives a substantial share of revenues (approximately 13.5%) in the form of royalties and, in addition, the company receives any excess after debt service and priority expenses are paid. Redirection would therefore not necessarily yield any significant increase in cash flows – an extra approximately USD[146]m per year (i.e. the largest debt service amount per annum for the term of the transaction assuming a coupon rate of 7%).

Corporate and Market Risks

Further Indebtedness

Fitch considered in its analysis the risk that the seller parties may incur additional debt from corporate and other activities (e.g. M&A, see *Seller/Servicer Background*), which may create additional stresses for the transaction. This risk is mitigated by the transaction's requirement that each of the seller parties covenant not to incur additional indebtedness (including contingent obligations or lease obligations) other than (i) any obligations under the transaction documents, (ii) obligations to trade creditors payable within 180 days of their incurrence and (iii) obligations under operating leases for capex that does not exceed USD35m per annum (and not exceeding USD320mn on a cumulative basis for the term of the transaction). Fitch has built the capital expenditure requirements into its cash flow analysis.

The transaction documents allow for the issuer to issue additional notes under the structured export note programme, which may be *pari passu* with or subordinated to the notes only if no early amortisation event occurs as a result of the additional debt issuance. A further proviso is that Fitch does not withdraw its rating or downgrade it below the lower of the then-current rating and the 'BBB-(BBB minus)' expected rating assigned.

Fitch notes that the above requirements ensure that substantially all of the seller's debts consist of the debt issued under the current transaction. This reduces the risk of additional creditors being introduced outside the structure, whose interests may not be aligned with those of the transaction investors in situations of financial distress.

Willingness to Pay

The agency notes that future flow transaction may be subject to the management's discretion to redirect payments or divert obligors to pay into accounts other than those specified by the transaction documents. This risk is addressed by the fact that the transaction is structured as a "true sale" of existing and future export receivables to the issuer, and the export obligors are irrevocably instructed to pay their invoices into collection accounts in New York, held by the security trustee. All cash flows received from the receivables will flow through collection accounts, and the management or parent of the seller parties will have no access to them before debt service, priority production, marketing, royalty and estimated tax expenses have been made. These features mitigate risks relating to willing-to-pay.

Asset Diversion
The CCOWs can be viewed as the "key asset" held by KPC and Arutmin. Fitch has considered the risk that the seller parties may transfer this asset to another party that does not operate under the auspices of the transaction. Since the operating contractors and the marketing agents (both existing and new) will have their contracts assigned to the indenture trustee, any third-party concession-holders will be unable to use the same parties. Furthermore, the obligors will agree to pay into relevant collection accounts as instructed, if they take delivery of coal shipped to them from any of the three ports located in the Province of Kalimantan, Indonesia, which are presently known as North Pulau Laut Coal Terminal, Tanjung Bara or Lubuk Tutung, or any other location in the immediate vicinity.

Coal Diversion
As pointed out in the GCA analysis, a key strength of the transaction is KPC's hard currency income and strong network of international off-takers. Fitch considered the risk of coal diversion to the Indonesian domestic market, which would increase the weight of Rupiah cash flows from weaker counterparties. These risks are addressed by the structure, which stipulates that at least 85% of total revenues from all coal sold in any period of 12 consecutive months must be from export receivables.

Spot Market Exposure
Fitch notes that the sellers benefit from long-term sales contracts, which carry greater off-take stability and price predictability (see *Off-take and Volume Risks* and *Pricing and Price Risks*). Relevant risks relate to the diversion of coal sales towards the spot market for speculative gains, which would expose the transaction to lower-quality and more volatile cash flows. Such risks are addressed by the transaction's requirement that 70% of export collections for any six-month period must have arisen from contracts with an initial term of one year or more, to be verified on a monthly basis by the transaction administrator.

Coal Price Risks
The seller parties' product prices are driven by supply-demand dynamics in the Asia Pacific region. While tight supply and strong demand have pushed coal prices well above historical levels, these pricing pressures are likely to abate over time (see *Pricing and Price Risks*). Consequently, the transaction's cash flows will likely be more robust in the initial period, but may become less so as the transaction ages and as coal prices settle at sustainable levels. Associated risks are addressed by the transaction's front-loaded amortisation structure, which aims to match stronger cash inflows with greater amortisation outflows, thereby reducing risks arising from mismatches between the two. This amortisation profile also greatly reduces refinancing risks that could otherwise arise at the end of the transaction period.

Marketing Agents
In the transaction structure, the marketing agents are paid from collections when invoices are paid by the relevant obligors. This aligns the marketing agent's interests with those of the seller parties in selecting creditworthy obligors. In any case, once an obligor defaults on one payment, no further products will be shipped to them, thereby mitigating further exposure to such obligors. To date, KPC and Arutmin have not experienced any delinquencies or losses with respect to any of their export obligors.

■ Legal and Structural Review

Notice and Acknowledgement
The transaction will require export obligors related to export contracts representing obligations to purchase, (i) to have received notification of assignment within five days and at all times thereafter; (ii) 40% in terms of aggregate tonnage of coal under a sale contract to have provided acknowledgement and/or consent within 3-6 months after closing, and (iii) 80% in terms of aggregate tonnage of coal under a sale contract to have provided acknowledgement and/or consent after 6 months and thereafter. Such obligors shall also undertake not to enter into any contract for the sale of coal produced by any seller party other than those involved in this transaction or the originator SPV. Any failure to meet the above requirements will constitute an early amortisation event.

Fitch has been advised that, to perfect the transfer of valid ownership of the receivables under the laws of Japan, Taiwan, Hong Kong, Malaysia, Korea, England, Singapore, Ireland, Switzerland, Indonesia and Israel, the seller parties shall have delivered to the applicable obligors a notice (in the manner required in the relevant jurisdiction and in accordance with the terms of the relevant contracts). In some jurisdictions, perfection may be achieved simply by providing notice to the obligors and may not require acknowledgement or consent. Fitch expects to review legal opinions relating to the various jurisdictions confirming this issue.

SPVs Set up by Bumi
Three of the SPVs set up for the transaction are subsidiaries of Bumi; two are incorporated in Indonesia and one in the Cayman Islands. The Indonesian SPVs are wholly owned by Bumi with the exception of one share apiece, which will be held

by an independent shareholder. The shares held by Bumi will be pledged to the security trustee. The Cayman SPV is 100% owned by Bumi, and its shares will also be pledged to the security trustee. Fitch has been advised by Indonesian counsel that there is no doctrine of "substantive consolidation" under Indonesian bankruptcy law and, in the event of bankruptcy of Bumi, the respective SPVs will not be consolidated with it and will therefore not be subject to claims by Bumi's creditors. An independent director will also be appointed at each Indo SPV, whose action is required to bind such Indo SPV. The independent shareholder and the independent director will agree not to exercise their powers in such a way that the Indo SPV will take actions contrary to the stipulations of the transaction documents.

Transfer of the CCOWs

The main "assets" of the transaction are the CCOWs and each seller parties' rights and obligations thereunder. Each CCOW essentially confers the rights to mine and sell coal to each of the seller parties. Pursuant to a deed of transfer, the CCOWs will be transferred to KPC Indo SPV and Arutmin Indo SPV at closing. However, the completion of the transfer will automatically be triggered upon: (i) the declaration of certain trigger events; and (ii) one day before the date on which a declaration of bankruptcy or temporary suspension of payments becomes effective against either seller party as debtor under the Indonesian Bankruptcy Code ("IBC").

Fitch expects to receive a clean opinion from Indonesian counsel that only notice to (and not consent from) the government of Indonesia is necessary for the completion of the transfer. Fitch also expects to receive a clean opinion from Indonesian counsel that the transfer will not be subject to avoidance under the IBC.

Transfer of Future Receivables

The transaction is structured such that the originator SPV will be selling receivables that it generates (including future receivables) to the issuer on a true sale basis under English law or other appropriate choice of law governing the receivables sales agreements. However, as of transaction closing, during the interim period where existing contracts between the seller parties and their respective obligors may still be in effect, future receivables generated by such contracts may not be perfected, as the fundamental principals of Indonesian law do not give effect to the current sale of future receivables. As such, the actual transfer and delivery of the future receivables will be effected by having the servicer identify receivables in a servicer report as being delivered to the originator SPV as and when it comes into existence.

To further mitigate this risk, the law governing the receivables sale agreements between the seller parties and the originator SPV may be aligned with the law governing the underlying sales contracts, to minimise the potential for conflicts. To quantify this risk, Fitch estimates that the total value of contracts that may be affected is approximately 3.5% of Fitch's base-case projected revenues for the life of the transaction. Furthermore, the transaction documents stipulate that after the first 12 months of the transaction the amount of all receivables originated in the name of the originator during any period of 12 consecutive months shall not be less than 80% of the amount of all receivables originated in the name of the seller parties, the Indo SPVs and the originator during such period. The failure to meet this requirement constitutes an early amortisation event. Based on the above, Fitch believes the level of risk to the notes to be limited.

■ Stress Scenarios

Fitch's stress scenarios for the transaction focus on key risks to the transaction cash flows and their consequent impact on debt service coverage. The risks in this regard mainly relate to production and price – the former arising from a failure to ramp production up to targeted levels and the latter to the failure to achieve forecast prices during the life of the transaction.

Fitch notes that its debt service coverage calculations utilise cash flows remaining after operating expenses (including government royalties, contractor costs and marketing commissions) and required capital expenditures, assuming that the sellers employ the higher-cost and more lumpy capex options in their development plans.

Fitch constructed its base case by using production and price levels deemed reasonable by Minarco in its ITR. The resulting base case generates 13% less revenue and 27% less cash flow available for debt service than the seller parties' forecasts. DSCR levels in Fitch's base case averaged 4.1x, reaching lows of 2.6x.

With respect to production stresses, Fitch considered the impact of delaying Bengalon's ramp-up by one year, and capping production thereafter at Bengalon's targeted first and second year output levels (i.e. 6mtpa and 10mpta, respectively) in different scenarios. This envisages the highly unlikely scenario that KPC abandons Bengalon's ramp-up plans after the mine's initial ramp-up. Fitch draws comfort from the transaction's ability to

withstand such stresses and maintain average DSCRs at 3.8x and 3.6x, respectively (with lows of 2.5x in both cases).

Lastly, to employ stresses sufficiently severe to qualify as a 'BBB-(BBB minus)' stress, Fitch reduced all projected prices (off its base case) by 20%, while additionally applying the production stresses described above. The agency observes that, while DSCRs are severely affected by the combination of these stresses, they nevertheless allow the transaction to perform – albeit at average DSCRs of 1.7x, with lows of 1x.

Early Amortisation Triggers

The transaction incorporates several measurable early amortisation triggers, which serve as early warning mechanisms to protect investors when the transaction performance deviates drastically from expectations. Early amortisation could be triggered when:

- The excess cash flow coverage test or the projected excess cash flow test is not met – i.e. when residual cash flows after priority payments and all other non-priority payments fall to less than 2.0x the maximum quarterly debt service (the test being applied on a quarterly basis).
- The monthly average amount of eligible receivables as a percentage of all outstanding export receivables falls below 70% in any six calendar months.
- The production levels of the seller parties are less than 70% of budgeted levels for any of six full consecutive calendar months after closing.
- A failure to obtain effective acknowledgements from export obligors (as required by the transaction documents) that persists for 30 days.
- During any period of 12 consecutive calendar months, the amount of export receivables constitutes less than 85% of all receivables arising from the sale of export-grade coal originated during such period.
- Less than 70% of collections from export receivables for any six-month period arise from contracts with an initial term of less than one year.
- At any time on and after the first anniversary of transaction closing, the amount of all receivables originated in the name of the originator during any period of 12 consecutive months to be less than 80% of the amount of all receivables originated in the name of the seller parties, the Indo SPVs and the originator during such period.

On the occurrence of any early amortisation events above, the controlling party of the series of notes may choose whether or not to declare an early amortisation period. If it opts to do so, 70% of (or, upon acceleration of maturity of the notes, 100%) excess cash is trapped and applied to prepayment of the notes.

Performance Analytics

Fitch will monitor the transaction on a regular basis and as warranted by events. The agency's structured finance performance analytics ensures that the assigned rating remains, in the agency's view, an appropriate reflection of the issued notes' credit risk.

Please call the Fitch analysts listed on the first page of this report for any queries regarding the initial analysis or the ongoing performance.

Republic of Indonesia

On January 27, 2004, Fitch upgraded the ratings on Indonesia's sovereign local and foreign currency and obligations to 'BB-' (BB minus) from 'B+'. The Outlook on the ratings is Positive. This upgrade reflects Indonesia's reduced political risk, better policy initiation and coordination, anticipated bureaucratic and legislative reforms, stronger economic growth and continued improvements in the nation's public and external finances.

Indonesia's new administration has a strong public mandate and has recently further cemented its grasp over the legislature as the strength of the opposition alliance has diminished. Now that initial fears of a fragmented parliament have receded, the new government aims to remove obstacles to investment by deregulation and by reducing bureaucracy. Ongoing commitment to strict fiscal discipline should provide more scope for the public debt burden to continue on its downward path. Falling debt service costs, primary surpluses and accelerating economic growth provide more room for Indonesia's government debt-to-GDP ratio to fall below to 55% in 2005, close to the 53.5% median registered by "BB- rated" credits.

Risks on the external balance sheet front have also been significantly compressed. Although Indonesia's BOP position is still weighed down by its external debt servicing requirements, Indonesia's net external debt to current external receipts (CXR) is estimated to drop to 94%, down significantly from its post crisis high of 194%. The external debt service ratio has also been compressed to an estimated 28% of CXR in 2005, less than half the 63% ratio in 1999. Lastly, foreign exchange reserves have not dipped as severely as earlier expected, and are expected to stay around USD36 billion in 2005. The liquidity ratio of 90% is in line with other BB- credits.

Mindful of the need to run current account surpluses so as to cope with external financing requirements, the government has embarked on long-awaited efforts to raise export competitiveness through a more investor friendly environment. Key areas of investor concerns being addressed include onerous labour laws and local government regulations and reducing the scope for corruption which contribute unnecessarily to the cost of doing business. While these goals may prove difficult to implement and will only have a noticeable impact over the medium term, clear signs of progress could have large benefits on investor sentiment.

Policy credibility remains the key to macroeconomic stability. The authorities need to strike the right balance in managing upward inflationary and interest rate pressures, especially since the government is relying heavily on the domestic bond market to meet the bulk of its financing needs. The premium on successful exchange rate management is high in view of rising global interest rates, a rising import bill and higher amortisation payments in the near term. Positive factors would be continuing macroeconomic stability and a strong reform agenda amidst reviving investment demand. Conversely, failure to exploit the current window of opportunity would be disappointing - a weak reform agenda would erode market confidence and the outlook for sovereign creditworthiness over time.

Strengths

- Reduced political uncertainty
- Stronger policy initiation and coordination
- Declining public debt burden
- Improving external balance sheet
- Stronger economic momentum amidst renewed domestic investor interest

Weaknesses

- Uncertainty in the legal and judicial system
- Underinvestment in natural resource sector in recent years
- Weak non-oil tax revenue
- State owned enterprises reform and privatization has been slow

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