

Letter to Merrill Lynch, Australia and New Zealand Banking Group (ANZ), Cornell Capital, Development Bank of Singapore (DBS), and Cellmark from 93 NGOs in 27 Countries regarding Environmental, Social and Financial risks related to the United Fiber Systems pulp and chip mills and the Kiani Kertas pulp mill in Kalimantan, Indonesia

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To:
Merrill Lynch
Australian and New Zealand Banking Group (ANZ)
Cornell Capital
Development Bank of Singapore (DBS)
Cellmark

United Fiber Systems is a publicly owned company listed in Singapore, with plans to acquire and expand the Kiani Kertas mill in East Kalimantan and to build a new 600,000 tonne/yr pulp mill in South Kalimantan, with construction on a 700,000 tonne/yr wood chip mill now underway in Pulau Laut off South Kalimantan. We are writing with deep concern regarding your current or potentially

expanded involvement in these projects. We would like to draw your attention to the following deep concerns detailed in the enclosed “Memorandum on Environmental, Social, and Financial Risks Associated with the UFS Pulp and Wood Chip Mills and the Proposed UFS Acquisition of the Kiani Kertas Mill”:

- 1) The tremendous level of environmental and social risk associated with the UFS and Kiani Kertas mills; the association of forest crime and logging of natural forest with Indonesia’s industrial forest sector; and the poor performance of Indonesia’s timber plantations. In addition, the company’s own environmental analysts identify substantial environmental problems likely to be associated with port construction, including a decrease in water quality, soil quality, marine life abundance, a deterioration of public health, increasing air pollution and coastal destruction. Reports from the port site indicate that significant environmental damage, including the illegal destruction of coral reefs for construction material, has already occurred during the early stages of the UFS wood chip mill port construction.
- 2) The high level of political and financial risk due to the substantial involvement in these projects of “Politically Exposed Persons” (PEP), convicted felons, “Politically Exposed Companies”, and an impenetrable maze of Indonesian and European shell companies registered in the British Virgin Islands and Mauritius. These risks are compounded by the widespread climate of corruption in Indonesia, the fact that many of the PEPs are close business associates of former General Soeharto and the existence of significant questions regarding transactions involved in the proposed sale and purchase of Kiani Kertas.

Given your stated commitments to environmental protection, ensuring a sustainable forestry sector in Indonesia, and the well-being of local communities;

Given the World Bank Group’s refusal to provide support for the UFS projects;

Given the Indonesian Government’s identification of illegal logging as a predicate offense for money laundering;

Given requirements under the European Union, the Monetary Authority of Singapore, and United States and Indonesian law requiring full compliance with Financial Action Task Force (FATF) Anti-Money Laundering rules, regulations, and laws and the FATF focus on:

- “Politically Exposed Persons” defined as “individuals who are or have been entrusted with prominent public functions, for example current and former heads of state, senior politicians, senior government, judicial, military officials, senior executives of state-owned companies, major political party officials and their close associates and family members”¹;
- Risks associated with providing financial and business services to government ministers or officials from countries with widely-known problems of bribery, corruption and financial irregularity;
- Cases where “those in power illegally amassed large fortunes by looting their country’s funds, diverting international aid payments, disproportionately benefiting from the

¹ Jersey Financial Services Commission, “Anti-Money Laundering Guidance Update,” 2001

- proceeds of privatizations, or taking bribes in return for arranging favorable decisions, contracts or job appointments”; and,
- Tracking the proceeds of such corruption which are often transferred to other jurisdictions and concealed through companies, trusts or foundations or under the names of relatives or close associates.

We strongly urge you to cancel plans for your support of these ill-advised projects.

Sincerely,

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Memorandum on Environmental, Social, and Financial Risks Associated with the UFS pulp and wood chip mills and the proposed UFS acquisition of the Kiani Kertas mill

Stephanie Fried, Ph.D.
Environmental Defense
November 2006

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I) Unacceptable Level of Environmental and Social Risk

Forest Crime and Forest Loss

In 2006, the World Bank concluded that “**forest loss and forest crime dominate the [Indonesian forestry] sector**”² and noted that “Indonesia is losing forests at a remarkable rate, one of the fastest in the world.”³ The Bank concluded that “**industrial timber demand exceeds sustainable supply**”, that “timber plantations are insufficient and performing poorly,”⁴ and that “forest conversion – an unsustainable harvest method – has been the fastest growing source of timber supply in recent years and is a major source of supply for pulp mills.”⁵ The Bank concluded that “as timber supplies in Sumatra and Kalimantan are depleted, harvesting pressure is moving from west to east, with Papua increasingly a target for commercial exploitation.”⁶ Highlighting the overcapitalization of Indonesia’s forest industry, the Bank concluded that forest sector financing has been creating inappropriate incentives and that the lack of sufficient due diligence continues to lead to unsustainable demand and “the same kind of debt, risk, and overexposure that contributed to the financial crisis of the late 1990s.”⁷

The Bank’s recent report highlights the fact that Indonesian government agencies “are considering several risky or ill-advised initiatives that will further threaten forest resources”, including “potential investments to further expand unsustainable industrial capacity.”⁸ We believe the UFS and Kiani Kertas projects are in this category. The Bank now advocates an approach of “following the money” which “targets the financial backers of forest crime”, ensuring that financial service providers “must become more active and prudent in relation to their customer’s financial transactions.”⁹ Given the overwhelming incidence of illegal logging associated with Indonesia’s paper and pulp industry, the international community is increasingly focusing on the financial institutions involved in this sector.

Regarding the potential for private sector partnerships, the Bank warns of overly-optimistic projections: “Efforts to increase financing in the forest sector or to work with individual firms would have to recognize that firms may misjudge costs, underestimate environmental impacts, and use overly optimistic future projections.”¹⁰

² World Bank, “Sustaining Indonesia’s Forests: Strategy for the World Bank, 2006 – 2009”, June 30, 2006, Pg 8

³Ibid, Pg 11

⁴ Ibid, Pg 8

⁵Ibid, Pg 8

⁶Ibid, Pg 8

⁷ Ibid, Pg 10

⁸ Ibid, Pg 13, 15

⁹ Ibid, Pg 16

¹⁰Ibid, Pg 18

Timber plantations are insufficient and performing poorly.

Many independent evaluations, including those by the CGIAR Center for International Forestry Research (CIFOR), have highlighted concerns regarding the lack of legal plantation timber sources for the proposed mills and mill expansion. Project proponents have continued to insist that they have a fully legal 100% timber plantation supply for their proposed mills but these claims do not seem credible. In 2004, Environmental Defense analyzed plantation establishment data presented by UFS to MIGA and identified highly suspicious accounting practices which appeared to grossly exaggerate the company's schedule of plantation establishment.¹¹ Field research by Walhi South Kalimantan has confirmed not only that the size of timber plantations claimed by UFS is significantly greater than their actual plantations but that UFS appears to be operating without the required government permits.¹²

It has long been known that many of the plantation lands claimed by UFS are, in fact, already utilized or planned for utilization by palm oil companies, mining companies, or have been reclaimed by local communities. An August 2006 report by Down To Earth (DTE) describes the example of PT. Hutan Rindang Banua (HRB), one of three plantations supposedly to supply the UFS chip mill. They found that the HRB plantation area overlaps with eleven oil palm plantation concessions, a coal mining company, and small-scale mining sites used by local people.¹³ In addition, they cite a 2004 Jaakko Poyry report estimating that of the 295,000 hectare concession, the maximum exploitable area was found to be 93,566, at most, given overlapping concessions and encroachment.¹⁴ By 2005, UFS had admitted that the plantation area had declined to 46,000 ha.¹⁵ Current estimates indicate that as little as 15,000 hectares of the HRB concession may have timber plantations in "good condition",¹⁶ that is, *only enough for 1.5 years of the wood chip mill's operations*. Reports from the field indicate that UFS has been attempting to re-negotiate its purchase contract with the government-run Inhutani II plantation, pressuring the plantation to supply timber far in excess of the agreed-upon sustainable level, when the mills first open. This seems to be aimed at ensuring that, initially, the mills will be visibly operating from 100% plantation timber, even if the source is not sustainable. If this deal goes through, it will result in the rapid stripping of assets from the Inhutani II plantation, instead of allowing a regular much smaller harvest at sustainable intervals. Apparently, UFS is also attempting to negotiate a reduction in payments to Inhutani II, despite an earlier agreement.¹⁷

On November 16, 2006, in a public meeting, the Head of the South Kalimantan Forestry Department (Dinas Kehutanan Kalsel), Ir. Sonny Partono MM admitted that the UFS "did not yet have a sufficient supply" of raw materials and that Environmental Impact Assessments had not been completed for the UFS chip mill (already built) and the UFS port, currently under construction. He also stated that "at this time the operating permits are being processed by the Department of Forestry."¹⁸ According to

¹¹ "Letter to James D. Wolfensohn from 65 NGOs in 19 Countries Concerning proposed MIGA Guarantee for the Controversial \$1.2 Billion UFS Pulp Mill in South Kalimantan", 1/11/04

¹² Berry Nahdian Forqan, Executive Director, Walhi, South Kalimantan

¹³ DTE, "No Chip Mill Without Wood: a Study of UFS Projects to Develop Wood Chip and Paper Pulp Mills in Kalimantan, Indonesia", August 2006 pg 9

¹⁴ DTE, pg 10

¹⁵ UFS, Annual Report 2005, pg 66 cited in DTE

¹⁶ DTE, pg. 11,12

¹⁷ Personal communication, anonymous.

¹⁸ Ir. Sonny Partono addressed the National Seminar on Pulp and Paper Industry and Development of Monoculture Timber Plantations held by Walhi South Kalimantan and CAPP on 16 November, 2006. Ir. Sonny stated that although the UFS chip mill had been constructed and the UFS port was currently under construction, Environmental Impact Assessments (AMDAL) had not been completed for either of these projects. According to Ir. Sonny, the AMDALs were still being written and if any environmental problems were found, UFS would have to alter its construction process, after the fact.

field reports from local NGOs, the chip mill was originally scheduled to begin operations in August, operations were then apparently re-scheduled to begin in October, and the most recent unofficial reports indicated that – due to a lack of raw materials – operations would not begin until March.¹⁹

Similar to conclusions made by independent experts in Indonesia, Europe, and the United States, the DTE analysis concludes that given the problems inherent in the UFS plantation timber supply, “it is likely that its companies will have to depend on destructive logging or illegal logging of natural forests, or both.”²⁰

Other Environmental Impacts, Labor Rights, and Human Health Risks

Environmental risks to local communities are significant. In 2003, CAPP, the Community Alliance for Pulp-Paper Advocacy documented four fishing villages, including those dependent on shrimp farming, which were likely to be significantly impacted by UFS plans for a wood chip mill and port facility.²¹ By 2006, Walhi South Kalimantan researchers had found that the construction of the port had already generated serious problems for local communities, including the illegal destruction of coral reefs and nearshore resources used by local fishers. It was not until Walhi South Kalimantan brought the illegal coral harvesting for UFS port construction to the attention of local authorities that any steps were taken to curb the coral reef destruction. Reports are now coming in of changes to depth and clarity of water along the beach at Ale-Ale.²² Currently the port is being constructed for the UFS PT. MAL chip mill. The port’s environmental management plan (RKL) identifies the following six significant areas of deep environmental concern to local communities associated with port construction:²³

- 1) Water quality: significant increase in turbidity and Total Suspended Solids as result of digging, land clearing, ship traffic, run-off from wood chip piles;
- 2) Marine Life: decline in number and diversity of marine species; general deterioration in public health may lead to higher incidence of environmentally-transmitted diseases, increase in water-borne illnesses, including diarrhea, dysentery, and malaria;
- 3) Air pollution, increased levels of dust, in excess of permitted levels;
- 4) Soil quality decrease due to leaching, soil compaction;
- 5) Increased erosion;
- 6) Movement of ships may generate waves causing costal abrasion;

Seminar participants pointed out that AMDALs involved – by law – a process of public consultation and needed to be completed prior to the initiation of construction, not after construction was finished. Ir. Sonny also indicated that UFS had not secured sufficient raw materials to operate the chip mill, as reported on the front page of the local paper, *Mata Banjar*: “Kaji Ulang Pembangunan Pabrik Pulp,” *Mata Banjar*, 11/17/06.

¹⁹ Local groups report company spokespeople indicating that a public announcement on the new proposed start-up date of the mill would be coming “soon.”

²⁰ DTE, pg 1

²¹ Report by Rivani Noor, CAPP, 12/17/03

²² DTE, “No Chip Mill Without Wood: a Study of UFS Projects to Develop Wood Chip and Paper Pulp Mills in Kalimantan, Indonesia”, August 2006, pg 20

²³ DTE, pg 19

Kiani Kertas pulp mill – East Kalimantan

According to local NGOs, the establishment of the Kiani Kertas pulp mill in East Kalimantan led to the displacement of indigenous communities from their forested lands and an influx of migrants from other regions. In addition to environmental and social problems associated with the loss of forest livelihoods and access rights and the heavy militarization of the region, labor conflicts have been generated by the project. East Kalimantan groups report news of recent strikes at Kiani Kertas by workers who indicate that they have not been paid by for several months by UFS, which is currently operating the Kiani Kertas mill. On October 30, 2006 more than 100 workers demonstrated at the Kiani Kertas plant.²⁴ Complaints against Kiani Kertas have been filed regarding firings of trade union leaders. Problems with land compensation have been significant, leading to conflict in communities impacted by mill development.²⁵

2) Unacceptable Level of Political and Financial risk

The UFS South Kalimantan and Kiani Kertas mill projects present extremely high political and financial risk profiles.

New Laws: Money Laundering, Forest Crime, and “Politically Exposed Persons”

Background information:

In 1989, the Financial Action Task Force on Money Laundering (FATF) was founded at the G-7 Summit in Paris with a goal of promoting national and international policies to combat money laundering and terrorist financing. The FATF meets several times per year and consists of legal, financial, law enforcement experts who monitor the status and progress of member countries, investigate money laundering, and promote the creation of appropriate global measures to combat money laundering.

FATF has identified a category of persons of concern, that is, Politically Exposed Persons (PEP). The PEP category is recognized by the European Union Anti-Money Laundering Directive, the Monetary Authority of Singapore, Notice 626, the U.S. Patriot Act, all of which identify Politically Exposed Persons as:

individuals who are or have been entrusted with prominent public functions, for example current and former heads of state, senior politicians, senior government, judicial, military officials, senior executives of state-owned companies, major political party officials and their close associates and family members.

Recent reports by the Center for International Forestry Research (CIFOR) have underscored the intersection between FATF rules regarding Politically Exposed Persons and Indonesia’s forestry sector.²⁶

²⁴ Jakarta Post, Freeport, Kiani Deny Firing Unionists, November 2, 2006

²⁵ DTE, pg 17

²⁶ M. Spek, Financing Pulp Mills: An Appraisal of Risk Assessment and Safeguard Procedures, CIFOR, 2005

CIFOR analyses underscore the fact that without bank financing, large-scale forest exploitation projects are simply not commercially feasible, given the cost of machinery, costs of harvest, processing, and transport. Increasingly, however, high-risk forest-based projects which, in the case of Indonesia often involve crimes such as illegal logging or the pollution of water and air by dangerous waste, are leading to significant legal risks to banks.

Financial regulations in Indonesia, Singapore, the European Union, the United States and many other countries now requires banks and other financial institutions to “know their customer”, understand the investment profile, the patterns of transactions, and range of accounts owned

In 2003, Indonesia passed landmark legislation (law 25/2003) making banks and other financial institutions responsible for transactions involving forestry and environmental crimes. The new legislation identifies illegal logging as a “predicate offence” for money laundering, meaning that money laundering charges and strict penalty schedules can now be applied to financial institutions engaged in projects that involve illegal timber harvesting. This approach seeks to prosecute the financial backers of illegal logging.

European Union, United States, Singapore, and other countries have recently adopted or are in process of adopting new Anti-Money Laundering (transparency) laws and a risk-based approach, described in the Anti-Money Laundering Guidance Update, Jersey Financial Services Commission, 2001²⁷. Under this framework:

- Banks are obliged to implement customer due diligence proportionally to the concrete risks involved in the project or transaction;
- Heightened focus on “Politically Exposed Persons “ and “Politically Exposed Companies”:
 - focus on risk associated with providing financial and business services to government ministers or officials from countries with widely-known problems of bribery, corruption and financial irregularity;
 - focus on cases where “those in power illegally amassed large fortunes by looting their country’s funds, diverting international aid payments, disproportionately benefiting from the proceeds of privatizations, or taking bribes in return for arranging favorable decisions, contracts or job appointments.”
 - Focus on tracking the proceeds of such corruption which are often transferred to other jurisdictions and concealed through companies, trusts or foundations or under the names of relatives or close associates.
 - Financial services businesses that handle the proceeds of corruption face risk of severe reputational damage, and criminal charges for having assisted in laundering the proceeds of crime, lawsuits;
 - Reduce risk by detailed due diligence at beginning and on ongoing basis where it is known or suspected that the business relationship is with a “politically exposed person.”
 - Must assess which countries are most vulnerable to corruption – use of the Transparency International corruption list is advised;
 - Must be most vigilant where customers are involved in businesses which appear to be most vulnerable to corruption;

²⁷ The notes below are taken from Jersey Financial Services Commission, “Anti-Money Laundering Guidance Update,” 2001

- Due diligence should include:
 - Close scrutiny of any complex structures (companies, trusts, multiple jurisdictions) “bearing in mind that most legitimate political figures would expect their personal affairs to be undertaken in a more than usually open manner rather than the reverse.”)
 - Make every effort to establish the source of the wealth, including the economic activity that created the wealth, establishing that these are legitimate – at beginning and on on-going basis
 - Development of profile of expected activity on the business relationship so as to provide a basis for future monitoring;
 - Review at senior management or board level the decision to commence the business relationship and regular review
 - Close scrutiny of any unusual features: very large transactions, use of government or central bank accounts, particular demands for secrecy, the use of cash or bearer bonds or other instruments which break an audit trail, use of small and unknown financial institutions in secrecy jurisdictions, regular transactions involving sums just below a typical reporting amount;

Kiani Kertas: Corruption Allegations, “Politically Exposed Persons”, Shell Companies, Environmental Problems, Failed Operations

The proposed UFS purchase of Kiani Kertas is a high risk investment. There is substantial involvement of Politically Exposed Persons, convicted felons and Indonesian and European shell companies registered in British Virgin Islands and Mauritius. Indonesia is well known as a country with corruption problems. These facts, given additional concerns about the appearance of a lack of “arms’ length” transaction in proposed buying and selling of Kiani Kertas must trigger extraordinary levels of due diligence for any financial institution considering engagement in this process.

Summary of findings regarding Kiani Kertas by CIFOR²⁸ and other researchers, for more details see Appendix I:

Kiani Kertas

- built 1998, by convicted felon and Soeharto associate, Mohammed “Bob” Hasan. After the fall of Soeharto, Hasan was forced to serve a significant prison term; Hasan is still apparently a minority shareholder;
- allegations of extraordinary levels of “mark up” corruption leading to one of the most expensive “construction costs” for any mill in Indonesia – cost: \$1.3 billion;
- ownership transferred to Soeharto’s former son-in-law, Prabowo Subianto, the former head of notoriously brutal Kopassus special forces and brother of Merrill Lynch Indonesia President Komisaris;
- claimed development of “sustainable plantation” of 183,000 ha at PT. Tanjung Redep Hutani
- from 1997 – 2002 PT. Tanjung Redep Hutany only planted 67,000 ha.; little planted since then; known for poor management, most plantations not likely to be harvestable;

²⁸M. Spek, Financing Pulp Mills: An Appraisal of Risk Assessment and Safeguard Procedures, CIFOR, 2005

- Plant has capacity of 525,000 tonnes/year; yet has never operated over 310,000 tonnes/year (60% of capacity – in 2001), other years (2004,2005) less than 60,000 tonnes/year;
- UFS has announced plans to operate KK at full capacity, with potential to increase capacity; despite the clear environmental and social risks of tremendously increasing production/timber consumption levels there has been no publication of any new social, environmental impact assessment;
- UFS now claims that its 700,000 t/yr chip mill can supply wood for Kiani Kertas via an agreement with Inhutani II;

The Kiani Kertas deal features striking lack of transparency and accountability – including politically exposed individuals and complex off-shore corporate structures.

Politically Exposed Persons involved in Kiani Kertas and the Kiani Kertas / UFS purchase deal:

- Wisanggeni Lauw – largest individual shareholder of UFS; close associate of Probosutedjo: ex-General Soeharto’s half-brother and former owner of UFS plantation [see Jakarta Post, 12 Oct. 2005: “Probosutedjo admits to bribing judges], former member of Indonesian Legislature; reported to have gained control over Probosutedjo’s shares in plantation company PT Menara Hutan Benua during Probosutedjo’s trial for felony fraud (trial resulted in his conviction);reported principal owner of Kingsclere Finance Ltd (British Virgin Islands) which has entered into two separate agreements to (1) purchase Kiani Kertas from owners (2) resell Kiani Kertas to UFS (where Lauw is largest individual shareholder); the Lauw-owned Kingsclere purchase and resale of Kiani Kertas to UFS has raised questions in financial circles regarding the lack of arm’s length transaction;
- Prabowo Subianto – President Director of Kiani Kertas, reportedly principal owner of Fayola (majority shareholder of Kiani Kertas), former head of Indonesia’s dreaded Kopassus special forces (See: Appendix II: Singapore Straits Times, *Prabowo Denied US Visa Under Torture Agreement*); former son-in-law of General Soeharto, presidential candidate in last Indonesian election, brother of current Merrill Lynch Indonesia President (“President Komisarisi”), Hashim Djojohadikusumo. Mr. Hashim and Prabowo’s wife (Soeharto’s daughter) played key roles in the notorious Paiton Power Plant corruption scandal, involving massive debt, and what the Wall St. Journal called “one of the most expensive power deals of the decade, anywhere.” (See Appendix II.) The Paiton debacle included, among other things “exorbitant prices for coal” directly benefiting non-bid contracts held by Mr. Hashim and Ms. Prabowo, both of whom refused to sign forms indicating that they were not participating in corrupt activities as part of the project.²⁹
- Mohamed “Bob” Hasan, close associate of General Soeharto and other military officials; former Minister of Industry and Trade; convicted felon; original owner, founder of Kiani Kertas, currently minority shareholder; notorious for unsustainable logging, including in East Kalimantan under his “Kiani” group;
- Luhut Pandjaitan, former Kopassus General; former Ambassador to Singapore; former Minister of Industry and Trade; President Commissioner of Kiani Kertas.

²⁹ Wall Street Journal, full article in Appendix II

Also:

Kang Hwi Wah – owner of over 10 million shares of UFS; former managing director of Amcol Holdings (Singapore); convicted of bribery;

Politically exposed companies and non-transparent shell companies:

Kingsclere Finance Ltd (British Virgin Islands); reportedly owned by Wisanggeni Lauw; contracts both to buy and sell Kiani Kertas; arms' length transaction concerns;

Fayola Investment Inc. (Republic of Mauritius); reportedly owned by Prabowo Subianto, controlling interest in Kiani Kertas;

P.T. Metra Tujuhdua; reportedly owned or closely associated with Mohamed “Bob” Hasan; Kiani Kertas minority shareholder;

Langass Offshore, Inc. (British Virgin Islands), reportedly entered in agreement to sell approximately \$150 million in Kiani Kertas bonds to Kingsclere; Unknown ownership.

Tektronix Industries, Ltd. (British Virgin Islands); reportedly owned by major shareholders of Swedish CellMark Holdings, with a 10 year purchase agreement with UFS;

Rejection of UFS and Kiani Kertas Projects by World Bank Group (World Bank, MIGA, IFC) and Private Banks

In 2004, 65 NGOs in nineteen countries successfully protested a plan by MIGA for the provision of a guarantee for proposed \$1.2 billion UFS chip mill (700,000 tonne/year) and pulp mill (600,000 tonne/year) in South Kalimantan due to

- (1) the significant overcapacity of Indonesia's paper and pulp industry and its links to rampant illegal logging;
- (2) the failure of Indonesia's pulp plantation sector in general, and the specific problems associated with the plantations for the pulp mill proposed for MIGA support;
- (3) the potential impacts on the local communities near the proposed pulp mill site, including fishing communities; and
- (4) the fact that the majority of the finance for this \$1.2 billion project would be provided by the China National Machinery and Equipment Import and Export Corporation, a Chinese state-owned enterprise placed under sanctions in July 2002 by the government of the United States under the Chemical Biological Weapons Sanctions Law.

After the MIGA defeat, UFS approached OeKB, Austria's ECA for support. OeKB turned them down on environmental grounds.³⁰ UFS continued to seek both public and private finance. In 2005, after

³⁰Anonymous, report to Global 2000, Austria.

environmental and corruption concerns were raised, Deutsche Bank and J.P Morgan withdrew from planned involvement in the UFS deal.³¹ In 2006, MIGA engaged in talks with UFS, but have now concluded that it is unlikely that they will provide any support for this project.³² The World Bank's Indonesia Country Director was more blunt. When asked during a September 2006 NGO meeting about the UFS and Kiani Kertas projects, he stated "We just don't think it's a good idea for the World Bank to support this project." Regarding the question of International Finance Corporation (IFC) finance for the UFS or Kiani Kertas projects, he replied that "the IFC would have to be crazy to support this project."³³ At the same meeting, MIGA's Acting Director of Operations and Global Head of Infrastructure, stated that "MIGA is not considering this project. We no longer have interest in it."³⁴ In October 2006, and IFC representative based in Jakarta further emphasized that:

- "IFC has not provided any loan or financing to Inhutani II or UFS. We have no plans to do so
- IFC has no relationship with UFS.
- IFC has had no communication with UFS in relation to it's [sic] wood chip mill on Pulau Laut."³⁵

Given the extraordinary levels of environmental and social risk as well as the involvement of a significant number of "Politically Exposed Persons," convicted felons, untransparent shell companies in a banking climate placing the burden of detailed scrutiny of potential money laundering activities firmly on the shoulders of financial institutions, it is no surprise that the World Bank Group is refusing to engage in this project.

³¹ Financial Times, "Merrill turns down UFS over Kiani funding," 23/02/2006

³² Meeting with Walhi South Kalimantan, NADI, Solidaritas Perempuan, Environmental Defense, September 2006.

³³ Meeting with Walhi South Kalimantan, NADI, Solidaritas Perempuan, Environmental Defense, September 2006.

³⁴ Ibid, Statement by Philippe Valahu, Acting Director of Operations and Global Head of Infrastructure, MIGA. After indicating that MIGA was not interested in supporting this project, Mr. Valahu was asked if there was any way that MIGA would ever consider this project at any point in the future. His response: "The only way it could be considered by MIGA is if, for example, ten years from now, on a sunny day, World Bank and all of you here agreed that it was a good idea, if the technical conditions were met, environmental concerns were met, with jobs created. Absent that, we wouldn't support the project."

³⁵ Letter from IFC representative (Jakarta) Moray McLeish to Chris Lang, 10/20/2006

Appendix I – More Detailed History of Kiani Kertas: Excerpts from CIFOR Report

CIFOR – C. Barr, “Profits on Paper” – This information is provided as general background information for the reader who may not know the history of Kiani Kertas. It is somewhat dated, but provides a very clear overview of the company and the mill.

Under the New Order regime, none of Indonesia’s major pulp and paper investors was better placed to access these discretionary funds than Kiani Kertas. Owned by former-President Soeharto’s long-time associate Bob Hasan, the company secured much of the financing for its 525,000 tonne greenfield pulp mill in East Kalimantan from the Indonesian government. When the mill was constructed in 1997, the company received at least US\$ 300 million in loans from four state banks, as well as a US\$ 100 million allocation from the DR reforestation fund (*Kompas*, 1999; Borsuk, 1997). The government further subsidized the mill by providing Kiani a 10-year holiday on corporate tax, including customs duties that would normally be charged on imported and exported goods.

One of Kiani’s special privileges has included the placement of a government Customs Office at the mill site. With its customs holiday, Kiani has been able to import capital goods directly to its mill and to export pulp without paying import-export duties, which are often on the order of 30 percent of the value of the goods themselves. It bears noting that as of November 2000, the Indonesian government continues to allow Kiani to enjoy this duty holiday.

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Bob Hasan’s Kiani Kertas pulp project is believed to have benefited substantially from the weak regulatory environment in Indonesia’s commercial banking sector. Through 1997 Bank Umum Nasional (BUN), in which Hasan was the majority shareholder, reportedly channeled 79 percent of its loans to sister companies (*Indonesian Commercial Newsletter*, September 14, 1998). It is speculated that much of this was channeled to Kiani while the mill was under construction, including a portion of Rp 6.8 trillion in liquidity credits that BUN received from Indonesia’s Central Bank in the early weeks of the crisis to keep the bank solvent (*Jakarta Post*, September 8, 1998). Through 1997, BUN reported operational income of only Rp 1.5 trillion.... As Figure 4.5 shows, the per unit costs of investments in Indonesia’s pulp industry have varied quite considerably. The Sinar Mas/APP group, which is often said to have among the lowest investment costs in the world, has reported spending approximately US\$ 1,100 per tonne of capacity in developing its Indah Kiat and Lontar Papyrus pulp mills (Asia Pulp & Paper, 2000).

By comparison, the Raja Garuda Mas/APRIL group spent US\$ 1,500 per tonne at its Riau Andalan Pulp & Paper facility. At the upper end of the spectrum, Bob Hasan’s Kalimantan group reportedly built its Kiani Kertas pulp mill at a cost of US\$ 2,600 per tonne (Spencer and Choi, 1999). Similarly, a partnership between Indonesia’s Barito Pacific group and the Japanese trading company Marubeni claims to have spent US\$ 2,700 per tonne in developing the Tanjung Enim Lestari (PT TEL) pulp plant (Bell, 1997). There has been strong speculation among financial analysts and industry sources that the relatively high costs of the Kiani Kertas and Tanjung Enim Lestari mills — each of which was roughly 75 percent above the industry’s intermediate costs of US\$ 1,500 per tonne of capacity — reflect substantial mark-ups during the investment process (*Pulp & Paper Online*, September 28, 1998).

If these reports are true, it suggests that these mills involved mark-ups that may have been as high as US\$ 577 million and US\$ 540 million, respectively. The owners of these mills would then have been able to use these funds however they wished, with few strings attached.

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In addition to their large offshore obligations, Indonesia's pulp and paper groups are responsible for over Rp 14 trillion in nonperforming loans that had been transferred to the Indonesian Bank Restructuring Agency (IBRA) through January 1999. Converted at the January 2000 exchange rate of Rp 6,700/US\$, this sum amounts to US\$ 2.1 billion. Just over one-third of this total – US\$ 728 million -- is owed to IBRA by four companies operating specifically in the pulp and paper sector. The largest of these is Bob Hasan's Kiani Kertas mill, which owes IBRA US\$ 370 million to rank ninth on the agency's list of over 4,000 corporate debtors. Kertas Basuki Rachmat, an integrated pulp and paper producer located in East Java, ranks eleventh on IBRA's list, owing the bank restructuring agency US\$ 244 million.

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In spite of the enormous loads of capital debt they were carrying when the financial crisis struck, none of Indonesia's major pulp and paper producers has been forced to halt its operations due to bankruptcy. Paradoxically, the capacity of these companies to continue operating has been due, in no small part, to the fact that they owe so much money. Many domestic and international financial institutions have, in fact, taken the view that the country's largest mills are too big to close. IBRA, for instance, has allowed Kiani Kertas — the seventh largest debtor in the agency's portfolio — to continue running its pulp mill in spite of the fact that the company is technically insolvent. Officials at the bank restructuring agency have claimed that keeping the mill in business is a necessary condition for IBRA to recoup close to US\$ 900 million in Bank Indonesia liquidity credits from Bob Hasan's Kalimantan group. These same officials, moreover, complain that due to the high investment costs associated with Kiani Kertas, any effort to sell the mill would yield only a fraction of its book value – meaning that IBRA would be forced to absorb a substantial loss in potentially collectible debt

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Kiani Kertas

As described earlier, Bob Hasan's Kalimantan Group received heavy government subsidies when it built its 525,000 tonne Kiani Kertas pulp mill in East Kalimantan. These included at least US\$ 300 million in loans from four state banks, an allocation of US\$ 100 million from the DR reforestation fund, and a 10-year tax holiday. In addition, the mill also reportedly benefited from Central Bank liquidity credits channeled to Hasan's Bank Umum Nasional (BUN) in the early weeks of the crisis. Bank Indonesia (BI) allocated Rp 12 trillion (or US\$ 1.8 billion at Rp 6,700/US\$) to BUN in late-1997 and early-1998 as part of the government's broader effort to shore up the nation's commercial banking sector following runs on some of the nation's largest banks (*Kompas*, February 8, 2000). BUN's management reportedly passed on much of these funds to Hasan-owned companies, including Kiani Kertas, which received an unspecified amount to cover "cost over-runs" at the mill (*Jakarta Post*, September 8, 1998). In September 1998, when IBRA moved to close Bank Umum Nasional for failure to repay the BI liquidity credits, Hasan offered to surrender Kiani Kertas to the bank restructuring agency in exchange for a US\$ 1.3 billion mark-down in its outstanding obligations (*Jakarta Post*, December 8, 1998). IBRA refused the offer, apparently believing the book value of the mill to be far higher than the real value of the asset. Instead, the agency worked out a repayment arrangement under which Hasan's group pledged 33 companies to IBRA as collateral for returning the BI liquidity credits over a set period of time (*Kompas*, December 8, 1999). Although the specific terms of the agreement have not been made public, the length of time for repayment has been reported variously as being either three or five years (Ausnewz, 1999). In the meantime, the companies are allowed to continue operating under the control of Hasan's Kalimantan group, as long as they stay on schedule in repaying the liquidity credits. This arrangement has raised questions within the financial community. As one analyst put it:

“What are the ethics of allowing a group of companies that have essentially embezzled several hundred million from the Central Bank to retain their assets and to pay this money back over time? Moreover, how is it that they have been left under the management of the same team that was running them before the crisis?”

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These concerns underscore two important issues: First, there is a general sense that a mill the size of Kiani is too large to close down. This, in turn, poses a moral hazard problem when the company or its affiliates are accused of mismanagement. Second, IBRA currently has little capacity to directly manage the assets in its portfolio. As a consequence, however, indebted companies have often been left to be run by their original owners – that is, the same actors that have been accused of mismanagement. In the case of Kiani, the company is simply pledged to IBRA, and the agency is unable to seize or liquidate its assets as long as the company abides by the negotiated repayment agreement.

In addition to the Hasan Group’s outstanding obligations related to the BI liquidity credits, Kiani Kertas itself is responsible for US\$ 370 million in nonperforming loans now in IBRA’s portfolio, as well as a unspecified amount of performing loans (Barr *et al.*, 2000). These loans have been transferred to IBRA by state and private banks that have been closed, taken over, or are being recapitalized by the bank restructuring agency. In October 2000, IBRA entered into a debt restructuring agreement with Kiani that covered some US\$ 628 million in both ‘sustainable’ and ‘unsustainable’ debt (IBRA, 2000; *Bisnis Indonesia*, 2000). According to the terms of the agreement, IBRA has agreed to reschedule US\$ 226 million in so-called ‘sustainable debt’ with an extended repayment period of 10 years (due in 2010, with a 2-year grace period) and a fixed annual interest rate of 12 percent. The Bank Restructuring Agency has also agreed to purchase US\$ 246 million in mandatory convertible bonds (MCBs), which can be converted to equity at any time. As described in Chapter Four, there are indications that IBRA will ultimately write off up to 70 percent of the nonperforming loans in its portfolio, effectively providing Indonesia’s forest and estate crop conglomerates with a capital subsidy that could reach US\$ 3.6 billion (Barr *et al.*, 2000). If we assume conservatively, that 50-70 percent of Kiani’s debt is written off, this would result in a subsidy of US\$ 185-260 million. The implications of such a subsidy become

somewhat more profound to the extent that the mill’s original price was marked up, as has been widely alleged. The structure of the mill’s financing is reported to have involved US\$ 530 million in vendor finance; US\$ 120 million in offshore bank loans; US\$ 510 million in domestic loans; and US\$ 140 million in equity from Bob Hasan (Ausnewz, 1999). If it is assumed that the real cost of the mill was on the order of US\$ 600-800 million, as many analysts speculate, then Hasan would have spent none of his own money and would have had at least US\$ 360 million in excess finance. If US\$ 260 million of this excess finance is now to be written off, it suggests that the mill will ultimately cost the Hasan Group between US\$ 340 million and US\$ 540 million. In addition to the subsidy that a substantial debt write-off would entail, there is also a moral hazard issue involved in keeping afloat a company that appears to carry a high degree of financial risk. Since it began operating, the mill has been run at between 50-70 percent of its total capacity due to both liquidity shortages and a series of technical problems (Ausnewz, 1999). Over the longer term, limitations on the mill’s raw material supply threaten to place severe constraints on the company’s earnings. According to Kiani’s original plan, the mill was to be fed by sustainably grown *acacia* wood from a 180,000 ha plantation run by an affiliated company, Tanjung Redeb Hutani. To date, however, the company’s planting has been well behind schedule, and since the crisis began, the area planted has reportedly not exceeded 5,000 ha per year – or less than one-quarter of its target (Ausnewz, 1999; PT Tanjung Redeb Hutani, 1996). Industry analysts also report that the company faces considerable problems establishing the infrastructure it will need to get

the wood from the plantation site to the mill when it is ready to harvest (Ausnewz, 1999; Jaakko Poyry, 1998)

As significantly, the new political climate has raised questions as to whether the mill will be able to get all the wood it needs. Since the fall of Soeharto, Bob Hasan's Kalimantan group has had several timber concessions revoked, including one in Berau, where Kiani Kertas is located. Partially for this reason, the mill has reportedly imported a substantial portion of its wood from Malaysia and Australia. This has added substantially to the cost of the company's operations and some analysts question whether the company will be able to maintain such a strategy through down-swings in the world pulp market.

Appendix II: Clippings

Jakarta Post, **Probosutedjo admits to bribing judges**

Jakarta Post, **Freeport, Kiani Deny Firing Unionists**

Wall St. Journal, **Power Deals With Cuts for First Family In Indonesia Are Coming Under Attack**

Straits Times, **Prabowo Denied US Visa Under Torture Agreement**

12 Oktober 2005, The Jakarta Post

Probosutedjo admits to bribing judges

(Eva C. Komandjaja, The Jakarta Post, Jakarta)

Former president Soeharto's half-brother Probosutedjo admitted on Tuesday to giving his lawyer Rp 6 billion (US\$600,000) to bribe the Supreme Court chief and other court officials dealing with his appeal against his graft conviction. Speaking after being questioned for four hours at the Corruption Eradication Commission (KPK), Probosutedjo said he intended to pay the bribe in order to win the appeal case as urged by his lawyer Harini Wiyoso. "I told Ibu Harini that I had no more money but what would I do if the verdict stipulated that I had to go to jail. Therefore, I tried hard to borrow the money," he said.

Probosutedjo insisted that it was Harini who suggested he bribe Supreme Court officials to overturn his jail sentence handed down by the lower courts. "She told me that Rp 1 billion would be paid to the court employees, and the remaining Rp 5 billion to Supreme Court chief Bagir Manan," he said. Bagir chairs the panel of judges handling the appeal case.

Probosutedjo was convicted of abusing reforestation funds that cost the state over Rp 100 billion in losses. He was sentenced to four years in jail by the Central Jakarta District Court in 2003, but the Jakarta High Court later reduced the term to two years. He was implicated in the bribery case following the recent arrest by the KPK of Harini and five officials of the Supreme Court for their alleged involvement in the scam. The KPK also confiscated some US\$400,000 and Rp 800 million, which it believed were to be used as bribes to win Probosutedjo's appeal case. Pleading innocence, Probosutedjo claimed that it was he who first reported the bribery attempt to the KPK last July after Harini offered to buy the Supreme Court verdict. "My friend Pak Sri Edi Swasono and I went to the KPK to report this matter since there were so many people in the Supreme Court who also offered to facilitate an acquittal in the appeal case," he said.

Sri Edi, the husband of the current state minister for women's empowerment Meutia Hatta, accompanied Probosutedjo to the KPK office for Tuesday's questioning.

Despite his bold confession, the KPK had not named Probosutedjo as a suspect in the bribery scam. Probosutedjo even failed to answer when asked why he paid the bribe, while on the other hand he reported the bribery case to the KPK in July. He said he never confirmed with Bagir whether the latter asked him for money in exchange for the verdict, arguing that it was impossible for him to meet the chief justice. Previously, Bagir denied allegations that he accepted a bribe from Probosutedjo through his court officials, but admitted he once met Harini and that when she started talking about the appeal case, he refused to respond. Senior lawyer and cofounder of the Indonesian Legal Aid Foundation

(LBHI) Adnan Buyung Nasution urged Bagir on Tuesday to step down while the bribery case was being investigated.

He said Bagir should show his responsibility as the Supreme Court chief by temporarily resigning from his position. "Putting aside the issue of whether he is guilty or not, it would be a more honorable move if Bagir stepped down temporarily because that would have a positive effect on the legal system in the country," Buyung said as quoted by Antara.

The bribery case has tarnished the credibility of the country's highest legal institution.

YLBHI director Munarman said that corruption in the country's judiciary system was rampant, affecting around 60 percent to 70 percent of court officials. "The corrupt system starts when someone reports a case to the police which then submit it to the prosecutors until the case reaches the court and there is the wait for a verdict," he added. He called on independent bodies such as the KPK and the Judicial Commission to take a more active role to eradicate such practices.

Freeport, Kiani deny firing unionists

Ridwan Max Sijabat, The Jakarta Post, Jakarta

November 2, 2006

Miner PT Freeport McMoran Indonesia and pulp and paper company PT Kiani Kertas have denied a labor union's claim they intimidated or dismissed workers who tried to organize.

The two firms are among 18 companies and two police precincts reported recently to Manpower and Transmigration Minister Erman Suparno by the Confederation of Prosperous Indonesian Labor Unions (KSBSI) for their allegedly illegal anti-union behavior.

Kiani Kertas spokesman Sukijo confirmed security authorities in Tanjung Redep, East Kalimantan, had deployed 63 Police Mobile Brigade officers to secure the company premises. The move followed a rally to protest the management's rejection of the recent establishment of a new KSBSI union at the company.

"We have vital assets and we don't want the labor unrest to disrupt operations. We need the security officers to ensure the operation will continue," he told *The Jakarta Post* by phone.

More than 100 workers staged a demonstration Monday to protest the management's rejection of the union at the company and the dismissal of seven activists.

However, Sukijo said no unionists had ever been dismissed from the factory. The management had never intimidated or dismissed workers who wanted to set up a union, he said.

"The workers have the right to unionize but they are required to comply with the law in exercising their rights," he said.

A majority of more than 1,300 workers employed in the factory and its industrial forests have joined the forestry sector Confederation of All-Indonesian Workers Unions (KSPSI), which has been the single partner with the management in negotiations to review their collective contracts.

PT Freeport spokesman Mindo Pangaribuan said management had never prohibited employees from setting up unions. The company had involved the KSPSI in negotiations to renew collective labor agreements, he said.

Freeport, a United States-based copper and gold mining company, employs more than 9,000 Indonesian and foreign workers at its Grassberg mine in Timika, Papua.

The union has also brought the cases to the labor court.

Law No. 21/2001 on workers and labor unions prohibits the management from intimidating and dismissing workers for their activism. It carries a maximum five-year jail sentence and a maximum fine of Rp 500 million against individuals or corporations violating the law.

The Indonesian Employers' Association (Apindo) confirmed it had received many complaints from labor unions about employers rejecting the establishment of new unions in their companies.

Apindo secretary general Djimanto, however, said union leaders often confused legitimate dismissals with unlawful ones.

Recent cases of workers' rights violations as reported by KSBSI

No. Company Location Victim

1. PT Freeport McMoran Timika, Papua 1 unionist dismissed
2. PT Dahana, Berau E. Kalimantan unionists transferred
3. PT Pangan Sari Utama Sorong, Papua 98 workers intimidated
4. Security authorities Pasir regency unionists intimidated
5. PT Rukun Tripilar West Java unionists dismissed
6. Army officials Pasuruan intimidation
7. PT S-4 Dumai Riau intimidation
8. Perum PPD Jakarta 3,000 members intimidated, unpaid
9. PT Mayasari Bhakti Jakarta 7 unionists laid off
10. PT Mitra Surya Eratama Tangerang 40 workers dismissed
11. PT Inti Kimiatama Perkasa Medan 3 unionists dismissed
12. PT Milan Indotex Jakarta unionists not registered with Jamsostek
13. PT Meindo Elang Indah Balikpapan SBSI units excluded from collective bargaining
14. PT Sumatra Sarana Sekar Sakti Medan rejection by management of SBSI unit
15. PT Bara Jaya Utama E. Kalimantan Workers intimidated by hoodlums
16. PT Karet Alam Aceh unionist dismissed
17. CV Salute, Sukoharjo C. Java nine unionist reprimanded
18. PT Inti Kimiatama Medan rejection of SBSI
19. Berau Police E. Kalimantan unionists intimidated
20. PT Kiani Kertas E. Kalimantan seven unionists dismissed

Source: SBSI

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Prabowo Denied US Visa Under Torture Agreement

Straits Times [Singapore] Sunday, December 31, 2000

Prabowo denied US visa under torture agreement

US says there is reason to believe the retired general, a son-in-law of Soeharto, was involved in torture and organising of rapes in the 1998 riots

By Susan Sim INDONESIA CORRESPONDENT

JAKARTA - A son-in-law of former President Soeharto, retired Lt-General Prabowo Subianto, has made legal history in the United States as the first person to be denied entry under the provisions of the United Nations Convention against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment.

A senior US official told The Sunday Times that a combination of foreign policy considerations, a reasonable belief that he was involved in the riots which devastated Jakarta in 1998 and coincidental timing worked against the former special forces general once lionised by his American counterparts as a future national leader.

'He was denied a visa in the middle of the year under the formal category of foreign policy,' the official said. 'The real reason is he is the first case of someone denied a visa subsequent to the United States ratifying the Torture Convention.'

Witnesses, he added, had testified to his involvement in the torture and organising of rapes during the May riots, both crimes covered under the convention.

Washington decided to make his case a precedent after 'considerable deliberations'.

Such a ban would tend to be permanent.

But Lt-Gen Prabowo, who has a son studying in Boston, was never given a reason why his visa application was turned down. Nor did Washington have any obligations to share the witness testimonies with ongoing probes in Jakarta into the riots.

The probes, first conducted by a human rights panel led by Attorney-General Marzuki Darusman, has never been able to find conclusive proof against Lt-Gen Prabowo, generally suspected by many to be the mastermind.

Victims and rape investigators, on the other hand, were subject to intimidation when they tried to testify.

The general, who was forced to retire after a military honour court here found him guilty of exceeding orders in the kidnapping of anti-Soeharto activists in 1998, later went into voluntary exile in Jordan before returning to Jakarta in May.

With a public still fascinated by him, he has given several interviews in efforts to clear his name.

Running into The Sunday Times last week when he made a lightning visit to the home of his academy classmate from the Class of 1974, Chief Security Minister Susilo Bambang Yuhdoyuno, he said he had never found out why he had been banned from the US.

THE WALL STREET JOURNAL

December 23, 1998

Power Deals With Cuts for First Family In Indonesia Are Coming Under Attack

By PETER WALDMAN and JAY SOLOMON Staff Reporters of THE WALL STREET JOURNAL
JAKARTA, Indonesia -- It looked like one of commercial diplomacy's finest hours: \$40 billion of business agreements signed between Indonesian and U.S. companies on a single day, honchoed personally by President Clinton and then-Secretary of Commerce Ron Brown. The date was Nov. 16, 1994, at the Asia-Pacific economic summit here. Among those deals, U.S. companies especially cleaned up on one of the world's most coveted emerging-market opportunities at the time: Supplying electric power to Indonesia's booming economy. Winners included Unocal Corp., CalEnergy Co. and a \$2.5 billion joint venture led by Edison International's Mission Energy unit and General Electric Co.

"As markets expand, as information flows," said a beaming Mr. Clinton to Jakarta's business elite after the signings, "the roots of open societies will grow and strengthen and contribute to stability."

Electric Bill

Today, of course, Indonesia is struggling to stave off anarchy. Far from being a force for stability, most of the power deals have only contributed to the chaos here. They underscore how American companies operated in President Soeharto's Indonesia -- and how, critics say, they cut overpriced, politically influenced deals that undermined the Indonesian economy. In the end, the deals may prove costly for many of the American companies, as well.

Most of the billions of dollars of U.S. electric-power investments in Indonesia went through cronies and relatives of Mr. Soeharto, who was ousted in May after 32 years of dictatorship. Nearly all the Soeharto relatives involved in the power projects got shares in joint ventures from their American partners without investing money of their own. The Mission-GE megaproject, Indonesia's first private-power venture, set the tone: It bagged one of the richest private-power contracts of the 1990s when its local partner, a relative of Mr. Soeharto by marriage who received shares in the project essentially free, sealed the deal by getting Mr. Soeharto himself to in in favor of Mission-GE at a key juncture in price negotiations.

Now, because of Indonesia's economic crisis, the country's state-owned electric utility, called PLN, is \$2.6 billion in debt and is effectively broke. Yet the utility -- and through it, ordinary Indonesians -- are on the hook for decades to come for high-priced power that, even in the go-go years when the projects were proposed, many of its own technocrats and foreign consultants argued Indonesia neither needed nor could afford. Only one of Indonesia's 26 private-power contracts was competitively bid -- one reason the average contracted cost of privately produced power here is 30% higher than in the rest of the world, according to Deutsche Bank AG. Adjusted for local purchasing power, the contracted cost of private electricity is 60% more than in the neighboring Philippines and 20 times as much as in the U.S.

Command Economy

The U.S. "power companies dictated terms to us because they had Indonesia's first family behind them," says Djiteng Marsudi, PLN's president from 1995 until his dismissal this summer after he complained publicly about corruption. "Resisting them was like suicide."

Government lawyers say they are marshaling evidence of Soeharto-linked corruption to push for renegotiating electricity rates with private producers. Many of the projects have been delayed. PLN is paying several electricity suppliers just 30% of their contracted rates. It has told Mission-GE it

doesn't plan to buy any electricity at all from the consortium's 1,230-megawatt coal-fired plant next year, when it is scheduled to go on-line. That would cost the project hundreds of millions of dollars.

"Based on what I've seen, there's plenty of ammunition to wage war and get the banks and sponsors to eat their share of the losses," says Peter Jezek, private-power adviser to Indonesia's ministry of mines and energy from 1990 through 1995. But he and others see a potential obstacle: Though Mr. Soeharto has moved on, many of the ministers who helped put together the deals are still in power.

Mission, GE and other power companies say they did nothing improper to land their contracts. Several power companies are taking PLN to arbitration to force it to honor the pacts. They say the real problems are the collapse of Indonesia's currency and the perennial mismanagement of PLN -- neither the fault of power developers, most of whose plants haven't even come on-line yet.

Paying the Consequences

"It's the exchange rate, stupid," says D. Reid Morgan, a managing director of Chase Manhattan Corp., which syndicated \$1.8 billion of loans for the GE-Mission project, called Paiton One. The U.S. also has been pushing Indonesia to stick to its commitments. George Munoz, president of the U.S. Overseas Private Insurance Corp., a federal agency that has \$665 million of exposure to Indonesia, much of it from power deals, recently said in Jakarta: "The contracts have to be honored."

Critics say corruption dogged the power deals from the start. When government advisers from power consultant Lahmeyer International AG, Lazard Freres & Co. and other Western firms complained about what they regarded as exorbitant prices for coal in the Paiton One project, senior Indonesian officials ordered the consultants to stop reviewing fuel costs immediately, the advisers say. "We were slapped back so fast our heads were spinning," says one. The plant's coal costs 30% to 40% more than coal at other PLN plants.

The advisers say there's no mystery about why they were shut out. Paiton One's exclusive coal supplier is a company co-owned by the Mission-GE group's Soeharto-clan partner, Hashim Djojohadikusumo, and Agus Kartasasmita, brother of then-Minister of Mines and Energy Ginandjar Kartasasmita, who was a key early booster of Paiton One. They got the coal contract without competitive bidding.

Mr. Ginandjar, who is now Indonesia's top economics minister, denies promoting Paiton One in any way. He emphasizes that many of the project's key terms and contracts weren't finalized until after he left the ministry of mines and energy. Mr. Hashim, whose family has been close to the Soehartos for decades, says his coal is priced at a premium because of its environmentally friendly low sulfur content; technocrats involved in the project say that doesn't justify the high price.

In addition to the coal contract, Mr. Hashim, Agus Kartasasmita and some partners received a 15% stake in Paiton One without investing any cash. To pay for those shares, Mission, GE and Japan's Mitsui & Co., also part of the Paiton One consortium, extended a \$49.6 million loan to the Indonesians. The loan was to be repaid from project dividends, the companies and the recipients of the loan confirm. This so-called carried-interest arrangement was a staple of Soeharto crony capitalism. Mission and GE say extensive reviews by their lawyers found no problems with making the loan. Many experts on U.S. anticorruption laws say carried-interest arrangements are generally legal, although others disagree. The Foreign Corrupt Practices Act bars U.S. companies from paying foreign officials for business favors, but not from assisting local partners.

Mr. Hashim says GE hectored him to sign "all sorts of forms" assuring that there would be no corruption. The forms aren't required by law but are used by some companies as protection against possible corruption allegations. Mr. Hashim wouldn't sign. "I said, 'Look, I'm an Indonesian citizen doing business in Indonesia,' " he recalls. "I said, 'No, it's a deal-breaker.' " Finally, after Mr. Hashim pointed out Mission "can live with this," he says, "GE didn't argue."

In Stamford, Conn., a GE Capital spokesman said it did "extensive due diligence" on Paiton One and its Indonesian partners and found nothing improper. Mission Chief Executive Edward Muller says its dealings with Mr. Hashim and other actions in pursuit of the Paiton One contract were legal and proper, adding that terms of the deal were "negotiated vigorously" over years by the Indonesian government and its "world-class advisers."

Faced with a similar issue, Entergy Corp., New Orleans, pulled out of Indonesia, according to executives familiar with the case. They say Entergy's partner, Siti Hediati Prabowo, Mr. Soeharto's second daughter and Mr. Hashim's sister-in-law, flew into a rage when Entergy lawyers insisted she sign some anticorruption documents. Entergy dropped the deal, executives say. An Entergy spokesman declines to comment; Ms. Prabowo didn't respond to requests for comment. Atlanta-based Southern Co., the biggest U.S. power producer in Asia, also backed away from Indonesia because of concerns over cronyism and other risks, its executives say.

CalEnergy, Omaha, Neb., linked up with Mr. Soeharto's oldest son, Sigit Harjojudanto, Indonesian officials and others say. Government records available to anyone in Jakarta for 30 cents show Mr. Sigit is majority owner of the Indonesian company that was CalEnergy's original partner in a geothermal project in Bali. Indonesian officials and one former CalEnergy executive say they were well aware that Mr. Sigit was CalEnergy's partner.

CalEnergy says it didn't know that Mr. Sigit was a partner, and that it is unaware that any of its Indonesian partners have ties to the Soehartos. It says company policy mandated that CalEnergy avoid deals with partners linked to the family. Mr. Sigit didn't respond to requests for comment.

Mission-GE's Paiton One project got political support on both sides of the Pacific. In addition to a slew of U.S. congressmen and senators who wrote letters for the project, Dan Quayle, Robert Rubin and Ron Brown all pushed for Paiton One at various times while they were in government. Warren Christopher and Henry Kissinger pushed for it as Mission-GE lobbyists. To nail down the deal, the U.S. Export-Import Bank and its sister agency, OPIC provided \$805 million of loans and political-risk guarantees, one of their biggest joint commitments ever.

In Jakarta, however, technocrats were alarmed by where the project seemed headed. Indonesia's economy was growing 7% a year in the early 1990s; the nation needed more electricity. But government planners knew PLN was in no shape to handle big private-power initiatives. The utility's transmission grid leaked like a sieve. PLN was seldom allowed to raise rates for fear of social unrest, yet it was milked for huge markups by politically linked suppliers and contractors.

So the advisers urged caution. Mr. Jezek, the government power consultant, recommended starting with geothermal and small gas-fired plants that could be expanded once PLN tackled its many problems. He and others also argued for competitive bidding. Instead, Mr. Soeharto, Mr. Ginandjar and Research and Technology Minister B.J. Habibie, now Indonesia's president, hand-picked

developers to lead the charge into big, high-risk, coal-fired power stations, Mr. Jezek and other advisers say.

"Ginandjar told me Indonesia had nothing to learn from the private-power experiences of Pakistan, the Philippines and Latin America, because Indonesia wasn't a banana republic," says Mr. Jezek.

Mr. Ginandjar says he doesn't recall that conversation. He says he doesn't dismiss other developing countries' private-power experiences, and in fact commissioned studies of them. He notes that the World Bank and other multilateral agencies were pushing big power projects.

At Paiton One, cronyism reared up from the start. According to Paiton One project documents, Mr. Soeharto, after a personal appeal by then-Vice President Quayle, first chose closely held Intercontinental Electric Inc., Hingham, Mass., along with the president's second son, Bambang Trihatmodjo, to build the first Paiton plant. (Mr. Quayle declines to comment.) The \$1 billion in debt the project required put Indonesia over its self-imposed limits on foreign debt at the time. Not only had Mission-GE lost out on the first Paiton deal, but it couldn't do other power projects in the country because they would further bust Indonesia's debt limits.

Mr. Habibie came to the rescue. In a December 1991 letter, he instructed Mission-GE to circumvent Indonesia's debt restraints by creating an offshore company to finance Indonesian power projects. It's not clear how that would have overcome the debt limits; in fact, many project advisers think it was pure artifice. Still, Mission-GE agreed to the plan, praising Mr. Habibie's "innovative and creative approach" in a letter back to him. (Eventually, Indonesia allocated Paiton One enough borrowings so that the offshore mechanism wasn't needed.)

The Bambang-Intercontinental deal fell apart because of various disagreements over terms. Mission-GE won the contract on the rebound -- with conditions. The government ordered Mission-GE to negotiate a possible link with Mr. Bambang's consortium, and to purchase Paiton One's boilers -- among the costliest components in any power plant -- from ABB Combustion Engineering. Mr. Habibie was chairman of Combustion's state-owned Indonesia affiliate, according to a report by government-consultant Lahmeyer. Mr. Bambang was ABB Combustion's commercial agent in Jakarta, the company confirms.

Extra cost of the mandated boilers, over boilers Mission-GE had wanted: \$20 million.

An ABB Combustion spokesman says it sold boilers to Paiton One after winning bidding, but doesn't know other details of the bidding process. Mr. Bambang and Mr. Habibie declined to comment for this article, as did Mr. Soeharto.

Talks on Paiton One's electricity tariff dragged on for months. The Mission-GE consortium was asking 10.3 cents per kilowatt-hour of electricity, nearly double the government's bid of 5.2 cents. Indonesia's advisers disputed Mission-GE's cost justifications, particularly its estimates for construction costs, coal prices and return on equity. Mission-GE argued its projections reflected unexpected delays, extra construction demands by the government and a risk premium as Indonesia's first private-power venture.

The logjam broke in mid-1993. Indonesia's chief negotiator shocked his team by announcing the government would accept a tariff of eight cents. He offered no detailed case for the tariff, and the

government's Western advisers believed it was still economically indefensible. The advisers say they concluded that deals were being cut behind the scenes.

They were. After heated negotiations in which participants say Mission executives blew up at government officials for refusing to take Mission's offer to Mr. Soeharto, Mr. Hashim had gone to the president. Mr. Hashim's father was one of Mr. Soeharto's earliest economic ministers. Mr. Hashim's brother-in-law was governor of Indonesia's central bank. His brother was one of the fastest-rising army officers in Indonesian history -- and husband of Mr. Soeharto's daughter, Ms. Prabowo. (Through a partnership with Mr. Hashim, Ms. Prabowo also got a carried interest in Paiton One.)

In a July 1993 letter to Mr. Soeharto, Mr. Hashim presented Mission-GE's case. But the letter left out certain details. Comparing tariff proposals, Mr. Hashim described a 0.59-cent variation in one component of the pricing as "not a big difference." Actually, it meant \$53 million a year more for PLN to pay. Mr. Hashim followed up the letter with a private audience with Mr. Soeharto where the deal was struck, according to other project documents. In that meeting, Mr. Soeharto said Paiton One's tariff shouldn't exceed nine cents, in order to avoid "unrest and socio-political consequences," another letter from Mr. Hashim to Mr. Soeharto says. Soon after that, Mission told its partners in a memo that nine cents was "the magic figure" and suggested ways to structure a tariff of 8.99 cents by shifting more debt to OPIC, among other steps.

Three weeks later, the consortium submitted its "final offer:" 8.6 cents, on average, for 30 years. The technocrats had no choice but to accept, officials say. "It was a presidential decision," says Nengah Sudja, a former head of research for PLN. "Everybody knew it was nepotism, but we couldn't do anything about it." Mr. Hashim acknowledges speaking to Mr. Soeharto many times about Paiton One, but says the president's own aides and ministers advised him on tariffs and other issues.

The technocrats still hoped lenders would balk at the high price, especially after the World Bank and others started warning of looming overcapacity in electric supply. But in those days, Asian power deals were hot. When Dianne Rudo of the U.S. Ex-Im bank visited Jakarta to evaluate financing for Paiton One, several government and PLN officials told her they didn't want and couldn't afford Paiton One, recalls an American industry expert who accompanied her. This expert says political pressure in Washington in support of Asian power deals for U.S. companies made Ex-Im's backing inevitable.

Ms. Rudo, now with a different bank, declines to comment. A spokesman for the Ex-Im bank says it wasn't under inordinate pressure, and that the project looked viable when financing was approved in early 1995. "The bottom line from our point of view was that we were supporting 25-plus U.S. exporters," he says.

Mr. Muller, Mission's CEO, says that Paiton One's tariff in part reflects the fact that the consortium, at the government's request, built extra infrastructure at the plant, including coal-handling and storage facilities that serve other power projects too. He emphasizes that Mr. Hashim's involvement "in no way caused the tariff to be higher." GE sold much of its stake in the project after financing and the tariff agreement were finalized; a spokesman says that was a typical move for GE, which often finances and helps design big projects, then sells to take profits before the projects are completed.

Today, Paiton One stands as one of the most expensive power deals of the decade -- anywhere. By contrast, Indonesia's only competitively bid project, an even bigger coal-fired project

won by Entergy with Ms. Prabowo as a partner, struck a tariff of 5.8 cents, 32% lower than Paiton One's. (It was later that Entergy dropped out of that deal after its disputes with Ms. Prabowo over anticorruption forms, executives say.) A comparable coal-fired project in Sual in the Philippines, also competitively bid, has a 5.1-cent tariff. But Paiton One set the pricing benchmark for most Indonesian private-power deals that followed. An Indonesian power executive laments that after Paiton One, banks "expected the same spectacular returns" or they wouldn't lend.

Now the scramble is on to clean up the mess. It won't be easy. PLN, in addition to being broke, has less flexibility than ever to raise the electricity rates it charges Indonesians. Those rates have fallen to the equivalent of two cents an hour because of Indonesia's currency collapse. (Government subsidies are supposed to plug the gap between what PLN charges and the substantially higher tariffs it pays power suppliers.) The last time Indonesia raised energy prices, in May, the ensuing riots helped lead to Mr. Soeharto's downfall.

A Harvard Business School consultant has advised the government to renegotiate the power tariffs "to terms that would have emerged under competitive bidding." Mission's lawyer, former Secretary of State Christopher, recently visited President Habibie to propose talks on a possible new tariff, Mission says.

Other power producers are taking a tougher line. CalEnergy has taken PLN to arbitration over nonpayment of tariffs and alleged contract violations. CalEnergy's three geothermal projects in Indonesia owe local suppliers and contractors about \$30 million, which it isn't paying because, it says, the projects' bank loans have been frozen.

The standoff angers many Indonesians, who say the Americans should help pay for the allegedly tainted deals they helped foster. Drilling contractor Samuel Sahetapy has had to lay off workers because, he says, CalEnergy owes him more than \$8 million; CalEnergy confirms it owes Mr. Sahetapy's company money but won't say how much. "Indonesians can't find food," Mr. Sahetapy says. "And this big American company won't pay its bills."