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R2017-0036/1

February 21, 2017

**Closing Date: Friday, March 10, 2017
at 6 p.m.**

FROM: Vice President and Corporate Secretary

Indonesia – Regional Infrastructure Development Fund Project

Project Appraisal Document

Attached is the Project Appraisal Document regarding a proposed loan to Indonesia for a Regional Infrastructure Development Fund Project (R2017-0036), which is being processed on an absence-of-objection basis.

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Report No: PAD1579

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US\$100 MILLION

TO THE

REPUBLIC OF INDONESIA

FOR THE

REGIONAL INFRASTRUCTURE DEVELOPMENT FUND PROJECT

February 16, 2017

Social, Urban, Rural and Resilience Global Practice
East Asia and Pacific Region

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CURRENCY EQUIVALENTS
(Exchange Rate Effective January 31, 2017)

Currency Unit = Indonesian Rupiah (IDR)
US\$ 1 = IDR 13,350

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AIIB	Asian Infrastructure Investment Bank
AMDAL	<i>Analisis Mengenai Dampak Lingkungan</i> (Environmental Impact Analysis)
APBD	<i>Anggaran Pendapatan dan Belanja Daerah</i> (Local Government Budget)
Bappenas	<i>Badan Perencanaan Pembangunan Nasional</i> (National Development Planning Ministry)
BI	<i>Bank Indonesia</i> (Indonesia's Central Bank)
BLU	<i>Badan Layanan Umum</i> (General Service Agency)
BLUD	<i>Badan Layanan Umum Daerah</i> (Local-level General Service Agency)
BNPB	<i>Badan Nasional Penanggulangan Bencana</i> (National Disaster Management Authority)
BPD	<i>Bank Pembangunan Daerah</i> (Regional Development Banks)
BPK	<i>Badan Pemeriksa Keuangan</i> (Indonesia's Supreme Audit Institution)
BPS	<i>Badan Pusat Statistik</i> (Central Statistics Agency)
BUMD	<i>Badan Usaha Milik Daerah</i> (Local Government-Owned Enterprise)
BUMN	<i>Badan Usaha Milik Negara</i> (National Government-Owned Enterprise)
CAGR	Compound Annual Growth Rate
CPF	Country Partnership Framework
DA	Designated Account
DAK	<i>Dana Alokasi Khusus</i> (Specific Purpose Grant)
DAU	<i>Dana Alokasi Umum</i> (General Purpose Grant)
DBH	<i>Dana Bagi Hasil</i> (Revenue Sharing Grant)
DEG	German Investment and Development Corporation
DIPA	<i>Daftar Isian Pelaksanaan Anggaran</i> (government budget utilization document)
DG	Directorate General
DPRD	<i>Dewan Perwakilan Rakyat Daerah</i> (Local-level Legislature)
DSCR	Debt Service Coverage Ratio
EA	Environmental Assessment
EIRR	Economic Internal Rate of Return
EMP	Environmental Management Plan
ESIA	Environmental and Social Impact Assessment
ESMF	Environmental and Social Management Framework
ESMS	Environmental and Social Management System

ESSBCM	Environmental and Social Safeguards and Business Continuity Management
FI	Financial Intermediary / Intermediation
FM	Financial Management
FMA	Financial Management Assessment
GDP	Gross Domestic Product
GoI	Government of Indonesia
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDA	International Development Association
IDR	Indonesian Rupiah
IDSUN	Indonesia Sustainable Urbanization MDTF
IFC	International Finance Cooperation
IFR	Interim Financial Report
IIF	Indonesia Infrastructure Finance Facility
IIGF	Indonesia Infrastructure Guarantee Fund
IPPF	Indigenous Peoples Planning Framework
LARAP	Land Acquisition and Resettlement Action Plan
LARPF	Land Acquisition and Resettlement Policy Framework
LG	Local Government
LGDP	Local Government and Decentralization Project
LKPP	<i>Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah</i> (Indonesia's National Procurement Policy Agency)
LPP	<i>Lembaga Pembiayaan Pembangunan Indonesia</i> (Indonesian Development Financing Agency)
MDF	Municipal Development Fund
MDTF	Multi-donor Trust Fund
MIS	Management Information System
MoF	Ministry of Finance
MoHA	Ministry of Home Affairs
MPWH	Ministry of Public Works and Housing
MTR	Mid-term Review
NBFI	Non-bank Financial Institution
NCB	National Competitive Bidding
NIM	Net Interest Margin
NPL	Non-performing Loan
NPV	Net Present Value
OJK	<i>Otoritas Jasa Keuangan</i> (Financial Services Authority)
OM	Operations Manual
PASA	Programmatic Advisory Services and Analytics
PDAM	<i>Perusahaan Daerah Air Minum</i> (Local-level Public Water Utility)
PDF	Project Development Facility
PF	Process Framework
PIP	<i>Pusat Investasi Pemerintah</i> (Government Investment Center)
PP	<i>Peraturan Pemerintah</i> (Government of Indonesia Regulation)
PPP	Public-Private Partnership

PMK	<i>Peraturan Menteri Keuangan</i> (Regulation Issued by the Minister of Finance)
PMU	Project Management Unit
RDA	Regional Development Account
RDI	<i>Rekening Dana Investasi</i> (Investment Fund Account)
RETF	Recipient-executed Trust Fund
RIDF	Regional Infrastructure Development Fund
ROE	Return on Equity
ROI	Return on Investment
RPJMD	<i>Rencana Pembangunan Jangka Menengah Daerah</i> (District-level Medium-term Development Plan)
RPJMN	<i>Rencana Pembangunan Jangka Menengah Nasional</i> (National Medium-term Development Plan)
SBI	<i>Sertifikat Bank Indonesia</i> (Indonesia Central Bank Certificate)
SBU	Strategic Business Unit
SCD	Systematic Country Diagnostic
SLA	Subsidiary Loan Agreement
SMBC	Sumitomo Mitsubishi Bank Corporation
SMI	PT. Sarana Multi Infrastruktur
SNG	Subnational Government
SOE	State-owned Enterprise
SPSE	<i>Sistem Pengadaan Secara Elektronik</i> (e-Procurement System)
SUN	<i>Surat Utang Negara</i> (Indonesian Government Bond)
TA	Technical Assistance
UKL	<i>Upaya Pengelolaan Lingkungan Hidup</i> (Environmental Management Measures)
UPL	<i>Upaya Pemantauan Lingkungan Hidup</i> (Environmental Monitoring Measures)
US\$	United States Dollar
USDRP	Urban Sector Development Reform Project
WDP	Wajar Dengan Pengecualian (Qualified Audit Opinion)

Regional Vice President:	Victoria Kwakwa, EAPVP
Country Director:	Rodrigo A. Chaves, EACIF
Senior Global Practice Director:	Ede Jorge Ijjasz-Vasquez, GSURR
Practice Manager:	Abhas K. Jha, GSU08
Task Team Leader:	Marcus J. Lee, GSU08
Co-Task Team Leader:	Adri A.L. Poesoro, GSU08

INDONESIA
Regional Infrastructure Development Fund Project (P154947)

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PAD DATA SHEET

Indonesia

Regional Infrastructure Development Fund (P154947)

PROJECT APPRAISAL DOCUMENT

EAST ASIA AND PACIFIC

SOCIAL, URBAN, RURAL AND RESILIENCE GLOBAL PRACTICE

Report No.: PAD1579

Basic Information			
Project ID P154947	EA Category F - Financial Intermediary Assessment	Team Leader(s) Marcus John Jin Sarn Lee	
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints []		
	Financial Intermediaries [X]		
	Series of Projects []		
Project Implementation Start Date 10-Mar-2017	Project Implementation End Date 30-Jun-2020		
Expected Effectiveness Date 15-Aug-2017	Expected Closing Date 31-Dec-2020		
Joint IFC No			
Practice Manager/Manager Abhas Kumar Jha	Senior Global Practice Director Ede Jorge Ijjasz-Vasquez	Country Director Rodrigo A. Chaves	Regional Vice President Victoria Kwakwa
Borrower: Ministry of Finance Republic of Indonesia			
Responsible Agency: PT Sarana Multi Infrastruktur			
Contact: Telephone No.:	Emma Sri Martini 622180825288	Title: Email:	President Director corporatesecretary@ptsmi.co.id
Project Financing Data (in US\$ Million)			
[X] Loan	[] IDA Grant	[] Guarantee	
[] Credit	[X] Grant	[] Other	
Total Project Cost:	406.00	Total Bank Financing:	100.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	203.00
International Bank for Reconstruction and Development	100.00
Asian Infrastructure Investment Bank	100.00
Indonesia Sustainable Urbanization MDTF	3.00
Total	406.00

Expected Disbursements (in USD Million)

Fiscal Year	2017	2018	2019	2020	2021	0000	0000	0000	0000	0000
Annual	0.00	10.00	35.00	40.00	15.00	0.00	0.00	0.00	0.00	0.00
Cumulative	0.00	10.00	45.00	85.00	100.00	0.00	0.00	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Social, Urban, Rural and Resilience Global Practice

Contributing Practice Areas

Environment & Natural Resources, Governance, Transport & ICT, Water

Proposed Development Objective(s)

The project development objective (PDO) is to increase access to infrastructure finance at the subnational level through a financially sustainable financial intermediary.

Components

Component Name	Cost (US\$ Millions)
Component 1: Capital Support for RIDF	400.00
Component 2: RIDF Project Development Facility	6.00

Systematic Operations Risk- Rating Tool (SORT)

Risk Category	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Substantial
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Substantial
8. Stakeholders	Substantial

9. Other			
OVERALL		Substantial	
Compliance			
Policy			
Does the project depart from the CAS in content or in other significant respects?		Yes []	No [X]
Does the project require any waivers of Bank policies?		Yes []	No [X]
Have these been approved by Bank management?		Yes []	No []
Is approval for any policy waiver sought from the Board?		Yes []	No [X]
Does the project meet the Regional criteria for readiness for implementation?		Yes [X]	No []
Safeguard Policies Triggered by the Project		Yes	No
Environmental Assessment OP/BP 4.01		X	
Natural Habitats OP/BP 4.04		X	
Forests OP/BP 4.36		X	
Pest Management OP 4.09		X	
Physical Cultural Resources OP/BP 4.11		X	
Indigenous Peoples OP/BP 4.10		X	
Involuntary Resettlement OP/BP 4.12		X	
Safety of Dams OP/BP 4.37		X	
Projects on International Waterways OP/BP 7.50			X
Projects in Disputed Areas OP/BP 7.60			X
Legal Covenants			
Name	Recurrent	Due Date	Frequency
IBRD, Schedule 2, Section I.A.3		30-Sep-2017	
Description of Covenant			
By no later than September 30, 2017, the Borrower shall establish the arrangements for the management of the contingency fund at the Ministry of Finance.			
Conditions			
Source Of Fund	Name	Type	
IBRD	Article V, 5.01(a)	Effectiveness	
Description of Condition			
The Subsidiary Loan Agreement, acceptable to the Bank, has been executed and delivered on behalf of the Borrower and PT. SMI and has become effective and binding upon such parties in accordance with their respective terms, subject only to the effectiveness of this Agreement.			

Source Of Fund	Name	Type		
IBRD	Article V, 5.01(b)	Effectiveness		
Description of Condition				
The Co-financing Agreements have been executed and delivered and all conditions precedent to their effectiveness or to the right of the Borrower to make withdrawals under the Co-financing Agreements (other than the effectiveness of this Agreement) have been fulfilled.				
Source Of Fund	Name	Type		
IBRD	Article V, 5.01(c)	Effectiveness		
Description of Condition				
The procedures to intercept the fiscal transfers to subnational governments have been established by the Borrower.				
Team Composition				
Bank Staff				
Name	Role	Title	Specialization	Unit
Marcus John Jin Sarn Lee	Task Team Leader (TTL) (ADM Responsible)	Sr Urban Economist		GSU08
Budi Permana	Procurement Specialist (ADM Responsible)	Procurement Specialist	Procurement	GGO08
Novira Kusdarti Asra	Financial Management Specialist	Sr Financial Management Specialist	Financial Management	GGO20
Achmad Zacky Wasaraka	Team Member	Procurement Analyst	Procurement	GGO08
Adri Asmoro Laksono Poesoro	Team Member	Urban Economist	Co-TTL	GSU08
Amilia Aldian	Team Member	Transport Engineer	Urban Transport	GTI02
Anna P. Hebert	Team Member	Senior Operations Officer	Integrity	INTSC
Aswin Hidayat	Team Member	Consultant	Financial Management	GGO20
Chau-Ching Shen	Team Member	Senior Finance Officer	Disbursement	WFALN
Christopher Paul Crow	Team Member	Consultant	Financial Analysis	GSU08
Evarist F. Baimu	Counsel	Senior Counsel	Legal	LEGES
Indira Dharmapatni	Safeguards Specialist	Senior Operations Officer	Social Safeguards	GSUID
Irma Magdalena Setiono	Team Member	Water & Sanitation Specialist	Water and Sanitation	GWA02

Krisnan Pitradjaja Isomartana	Safeguards Specialist	Senior Environmental Specialist	Environmental Safeguards	GEN2A
Luciana Noto	Team Member	Operations Officer	Trust Fund Operations	EACIF
Pazhayannur K. Subramanian	Team Member	Lead Financial Management Specialist	Financial Management	GGO20
Pratyush Prem Prashant	Team Member	Consultant	Municipal Finance	GFM08
Rajivan Krishnaswamy	Team Member	Consultant	Municipal Finance	GSU08
Ria Nuri Dharmawan	Counsel	Counsel	Legal	LEGES
Sandy Juli Maulana	Team Member	Temporary	Economic Analysis	GSU08
Sri Hastuti	Team Member	Team Assistant	Procurement	EACIF
Taimur Samad	Team Member	Program Leader	Urban Development	EACIF
Thalyta E. Yuwono	Team Member	Sr Urban Economist	Urban Development	GSU08
Tuo Shi	Team Member	Urban Economist	Urban Development	GSU08

Extended Team

Name	Title	Office Phone	Location

Locations

Country	First Administrative Division	Location	Planned	Actual	Comments

I. STRATEGIC CONTEXT

A. Country Context

1. **Indonesia is undergoing a major and rapid structural transformation from a predominantly rural and agricultural-based economy to an urban service-based and manufacturing economy.** In 2013, Indonesia had an urban population of around 130 million or 52 percent of the total population, making it one of the most urbanized countries in Asia. By 2025, an estimated 68 percent of Indonesia's population will be urban.¹ Of the 20 million jobs created between 2001 and 2011, 18 million were in urban areas, marking a major shift in the employment base to cities.

2. **Indonesia's transformation is constrained by a large local infrastructure deficit, which threatens to stifle future growth and prosperity in Indonesia.** Levels of access to, and the quality of, basic services – such as clean water, sanitation, drainage, housing and transportation – are low and in many cases worsening. In 2015, only about 69 percent of Indonesia's population had access to clean drinking water, and just 30 percent of households in urban areas had access to piped water – a decline of four percentage points since 2002. Piped sewerage networks are present in only 12 cities, which in total serve only two percent of the urban population. The National Disaster Management Authority (BNPB) lists 22 cities at 'extremely high risk' of urban flooding, highlighting the need for comprehensive planning and investment in floodways, canals, retention basins and protections from sea-level rise. The Ministry of Public Works and Housing (MPWH) estimates that over 38,000 hectares of urban and peri-urban land are classified as slums. Urban road networks are unable to cope with the rapid growth in traffic, with an estimated 57 percent of local roads classified as being in bad condition. The modal share of public transport is low and decreasing: it was recently estimated at seven percent and five percent in large and medium-sized cities, respectively.

3. **The infrastructure gap in Indonesia also imposes a significant opportunity cost on Indonesia's economic growth and poverty reduction potential.** Inadequate infrastructure is consistently identified by firms as a constraint on their operations and investment in Indonesia.² If the infrastructure capital stock had grown by five percent annually over 2001-2011 instead of the actual rate of three percent, it is estimated that real GDP growth would have averaged 5.8 percent, a difference of 0.5 percentage points. If the infrastructure stock had grown by 10 percent annually, annual real GDP growth would have reached 7 percent.³

4. **Infrastructure investment in Indonesia has not caught up with pre-Asian financial crisis levels, and lags well behind regional competitors today.** Infrastructure played a key role in driving growth and poverty reduction in the 30 years prior to the 1997 Asian financial crisis. After falling off sharply due to the crisis, Indonesia's infrastructure investment has struggled to recover. Total infrastructure investment declined from an average of seven percent of GDP in

¹ Urban population growth in Indonesia increased at an average of 4.4 percent per year between 1960 and 2013, compared with 3.6 percent in China, three percent in India, and 3.4 percent in Philippines.

² World Bank, *Indonesia Economic Quarterly – Current challenges, future potential*, June 2011, pp.28

³ World Bank, *Development Policy Review 2014 – Indonesia: Avoiding the Trap*, 2014, pp 85

1995-97 to around 3-4 percent from 2011-2013.⁴ By comparison, neighboring countries such as Thailand, Vietnam and China registered rates of approximately seven, eight, and 10 percent, respectively.⁵ Not surprisingly, Indonesia suffers from some of the poorest infrastructure indicators in the region. In 1996, Indonesia ranked ahead of countries like China and Thailand in the Global Competitiveness Report's index of 'overall infrastructure quality', but by 2002 these countries had surpassed Indonesia.⁶

5. Decreased spending on the part of government, state-owned enterprises (SOEs) and the private sector caused the decline in infrastructure investment as a proportion of GDP.

Private sector investment experienced the biggest fall, declining from 2.3 percent of GDP during 1995-1997 to 0.4 percent from 2008-2011. This is a particular concern given the Government of Indonesia's (GoI) increasing focus on public-private partnerships (PPPs) to finance infrastructure development. Over the same period, infrastructure investment by SOEs and the central government fell by 1.8 and 1.9 percentage points, respectively, while subnational government spending increased by 0.9 percentage points. Subnational governments are now leading in infrastructure spending in Indonesia, accounting for 39 percent of total infrastructure spending in 2010-2011, and for more than half of national public investment in 2015.

B. Sectoral and Institutional Context

6. Currently available financing instruments in Indonesia are limited and ill-fitting for the nature and scale of the required urban and local-level infrastructure investment.

In recent years, Indonesia has developed PPP vehicles for commercially viable infrastructure (e.g. energy generation, distribution and transmission; toll roads; airports and ports), but the market for PPPs is oriented towards large-scale revenue-generating projects. Regulations have been amended recently to enable subnational governments to issue bonds for urban infrastructure, but municipal bonds remain untapped, and only the larger cities or provinces with high fiscal capacity would be in a position to issue such bonds in the absence of a mature municipal bond market.⁷ Subnational government budgets (APBD) can only be used to pay for small-scale projects or marginal improvements in basic services that take less than one year to complete, due to government budgetary rules.

7. Addressing the 'missing middle' for medium- to long-term infrastructure finance is a critical priority for GoI to meet the local infrastructure gap.

There are limited sources of project financing for subnational governments seeking to undertake multi-year investments that are economically viable even if not financially viable, such as water supply, sanitation, solid waste, drainage, affordable housing and urban transport projects. These projects generally have significant positive economic benefits, but may not always generate a clear or robust revenue stream.

⁴ World Bank, *Indonesia Economic Quarterly – Current challenges, future potential*, June 2011, pp.28

⁵ *ibid*

⁶ World Bank, *Indonesia Public Expenditure Review*, 2004, pp. 75

⁷ MoF recently issued Ministerial Regulation PMK 180/2015 (revising the earlier PMK 111/2012) on the procedures for issuing municipal bonds, including the administrative assessment process.

8. **The ability to significantly leverage private finance for economically viable infrastructure is constrained in the current environment.** At present, no banking or non-banking financial institution in Indonesia provides access to long-term financing for local public infrastructure investment. Although there are no specific regulations that hinder commercial banks from investing in such projects, banks typically focus on short-term, corporate balance sheet secured financing. As over 85 percent of Indonesian bank deposits are in products of less than one month's maturity, banks find it hard to manage the asset-liability mismatch of longer-term lending. Non-bank financial institutions (NBFIs), including pension funds, financing and insurance companies⁸, traditionally invest in less-risky, high and quick yielding investments such as time deposits, government bonds, and stocks.

9. **Although levels of subnational government borrowing are extremely low in Indonesia, the market potential is large and growing.** Consolidated subnational borrowing was estimated at only 0.07 percent of GDP in 2014, which is low for a middle-income country.⁹ Yet, many subnational governments have considerable borrowing capacity as a result of growing transfer revenues. The 30 largest cities in Indonesia are estimated to have an untapped borrowing capacity of approximately US\$ 3.8 billion, based on Indonesian norms. A market assessment conducted in 2015 on a subset of 15 of these cities estimated an overall local infrastructure investment financing gap of US\$ 11.1 billion against a borrowing capacity of US\$ 1.7 billion.

10. **A sound subnational indebtedness framework is in place in Indonesia.** GoI has regulations in place that impose conservative restrictions to regulate subnational borrowing consistent with international standards.¹⁰ The Ministry of Finance (MoF) restricts subnational borrowing to the lowest value of four 'binding' norms: (i) outstanding loans plus proposed loans should be less than 75 percent of the previous year's general revenue; (ii) the debt service coverage ratio (DSCR) should be at least 2.5; (iii) the loan value should not exceed the maximum allowed deficit; and (iv) total debt service should not exceed 20 percent of the sum of the general purpose grant (DAU) and revenue sharing transfer (DBH) so as to ensure adequacy in case of the need to intercept (i.e. the intercept rule).

11. **GoI has implemented a number of initiatives to expand access to subnational debt for infrastructure investment, with limited success.** The four primary GoI initiatives aimed to expand subnational borrowing include: (i) *Rekening Dana Investasi* (RDI); (ii) Regional Development Account (RDA); (iii) Subsidiary Loan Agreement (SLA); and (iv) *Pusat Investasi*

⁸ As of March 31, pension funds, financing and insurance companies are the three largest NBFIs in terms of assets or around 20 percent of the total assets of Indonesia's financial sector.

⁹ The average of subnational debt to GDP for developing countries was five percent in mid 2000s. In India, the outstanding states' debt to GDP peaked at 32.8 percent in 2003-2004. The debt share of GDP in Mexico was around 2.9 percent in 2011. (Canuto & Lili, 2013)

¹⁰ The regulatory framework governing subnational borrowing includes a series of laws and norms including Law No. 17/2003 on State Finances, Law No. 1/2004 on State Treasury, Law No. 23/2014 on Subnational Governments, and Law No. 33/2004 on Intergovernmental Fiscal Balance. These laws are complemented by regulations such as Government Regulation (PP) No. 30/2011 on Subnational Borrowing, PP No. 10/2011 on Grant and On-Lending Mechanisms, Minister of Finance Regulation (PMK) No. 83/2005 on on-lending mechanism and its subsequent amendments, PMK No. 183/2014 on maximum budget deficit and subnational borrowing, and PMK No. 47/07/2011 on intergovernmental transfer intercept mechanism in the case of subnational default.

Pemerintah (PIP). The RDI, RDA and SLA instruments have experienced significant arrears, whereas more recent PIP lending, while relatively small in scale and scope, has been comparatively more successful.

12. Concurrent to the need to expand access to finance for local infrastructure, greater effort is also required to improve the effectiveness and efficiency of spending at the local level. With the beginning of decentralization in Indonesia in 2001, the assignment of new functions to subnational governments was accompanied by massive shifts in spending away from the central government—subnational expenditure grew from 2.7 percent of GDP in 2000 to 7.2 percent of GDP in 2011. Although subnational governments are responsible for 60 percent of consolidated public infrastructure spending, this is barely sufficient to keep up with the depreciation of local public assets.¹¹ Subnational governments have lacked the technical, institutional or financial capacity to carry out strategic infrastructure investments and keep pace with rapidly expanding demand for local services. Addressing the effectiveness and efficiency of local government spending across all sectors is critical, in parallel to expanding access to finance.

C. Higher Level Objectives to which the Project Contributes

13. Alignment with GoI Priorities. The proposed operation aligns with GoI’s development priorities as defined in the National Medium Term Development Plan (RPJMN). The 2015-2019 RPJMN clearly states the massive need for infrastructure delivery through all modes, including subnational spending. One of the seven general policies for national development under the Plan is the acceleration of infrastructure development for growth and equity. Under the national development agenda articulated in RPJMN, one of the channels for increasing Indonesia’s productivity and international competitiveness is to increase the effectiveness and efficiency of infrastructure finance. More specifically, RPJMN also mentions the use of mechanisms such as a municipal development fund (MDF) for urban infrastructure.

14. Alignment with the Country Partnership Framework (CPF). The Project is also well aligned with the World Bank Group’s CPF for Indonesia for FY16-FY20 (Report No. 99172, discussed by the Board on December 3, 2015). In particular, Engagement Area 4: “Delivery of Local Services and Infrastructure”, includes a pillar on supporting sustainable urbanization, cities, including infrastructure financing options. This pillar focuses on key infrastructure sectors including: urban transport, water supply and sanitation, drainage, urban flood and disaster risk management, slum upgrading, solid waste management and urban pollution.

15. Alignment with the Twin Goals. The proposed operation contributes to the World Bank Group’s twin goals, of ending extreme poverty and promoting shared prosperity, through improving infrastructure and local service delivery. There is strong global evidence for the link between improved quality of infrastructure, economic growth and reductions in income inequality.¹² The proposed operation would support subnational governments’ investment in

¹¹ See Lewis and Oosterman, 2010.

¹² As demonstrated by empirical experience drawn from over 76 countries from 1980-2010. Better infrastructure quality was also found to be positively correlated with reductions in income inequality. IMF 2013.

critical environmental, productive and social infrastructure that will directly benefit the bottom 40 percent of Indonesians.

16. Alignment with other World Bank Engagements in Indonesia. The proposed operation is linked to a number of related Bank engagements on local service delivery. The Regional Infrastructure Development Fund (RIDF), as a horizontal domestic financing solution for urban infrastructure, is a core element of a GoI platform on sustainable urbanization which includes a series of Bank-supported vertical national sector investment programs and a technical assistance program (see Figure 1). The sector programs aim to provide capital investment subsidies and technical assistance to incentivize reforms, capacity enhancement and improved performance in specific urban infrastructure structures. The Bank recently approved US\$ 216.5 million of financing in support of an estimated US\$ 1.8 billion National Slum Upgrading Program. The Bank aims to deliver this fiscal year a US\$ 450 million operation in support of an estimated US\$ 1.1 billion National Affordable Housing Program. Additional programs under preparation and scheduled for delivery include national programs on urban water supply, urban sanitation and urban solid waste management. As a source of financing for potential local government co-financing contributions, RIDF relates closely to this pipeline of national government sector investment programs. The Programmatic Advisory Services and Analytics (PASA) on Sustainable Urbanization, with funding from the Indonesia Sustainable Urbanization Multi-donor Trust Fund (IDSUN MDTF), complements the platform with advisory support to GoI for the development of RIDF, national vertical sector programs and direct technical assistance to local governments.



Figure 1: RIDF and a National Platform on Sustainable Urbanization

17. The PASA on *Decentralization that Delivers* includes advisory support to MoF on strengthening the intergovernmental indebtedness framework as well as support for a broader agenda of enhancing the efficiency and effectiveness of local service delivery through the reform of the intergovernmental fiscal system. In this context, the operation also builds on the existing

engagement of the Local Government Decentralization Project (LGDP) that supports GoI in the use of performance-based incentives to enhance reporting and accountability of the Specific Purpose Grants (DAK) for infrastructure. Lessons have also been drawn from past engagements in urban service delivery. For example, the lessons from the Urban Sector Development Reform Project (USDRP) recommend that a financial intermediary solution would be more effective than direct on-lending to municipal governments, and that long-term operations and maintenance costs for urban infrastructure should be taken into account during the initial planning stage.

18. The proposed operation complements the Indonesia Infrastructure Finance Facility (IIFF) and Indonesia Infrastructure Guarantee Fund (IIGF), both of which aim to support GoI to leverage private finance into commercially-viable infrastructure projects in productive sectors. IIFF was established in 2009 as a mixed-equity private non-banking institution with the aim to provide long-term finance to commercially feasible infrastructure projects. IIFF shareholders include *PT. Sarana Multi Infrastruktur* (PT. SMI)—the responsible agency for this operation, ADB, IFC, DEG and Sumitomo Mitsubishi Bank Corporation (SMBC). IIFF maintains a portfolio of projects in toll roads, coal, hydro and gas-fired power plants, and telecommunications. IIGF was also established in 2009 and is supported by US\$ 29.6 million financing from the World Bank. IIGF aims to encourage private investment in commercially-viable infrastructure by mitigating the private sector’s exposure to government-related contractual risk through the provision of guarantees.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

19. The Project Development Objective (PDO) is to increase access to infrastructure finance at the subnational level through a financially sustainable financial intermediary.

B. Project Beneficiaries

20. The main Project beneficiaries are residents of those areas that will be served by the infrastructure subprojects funded by sub-loans under Component 1 of the Project.

C. PDO Level Results Indicators

21. Achievement of the PDO will be measured through two sets of results indicators: (i) increased access to infrastructure finance at the subnational level; and (ii) the financial performance and health of RIDF.

22. The measures of increased access to infrastructure finance at the subnational level are:

- The number of subnational governments receiving RIDF loans;
- The average loan size approved by RIDF;
- The average tenor of loans approved by RIDF.

23. The financial performance and sustainability indicators are:

- Return on RIDF assets;

- The ratio of non-performing loans (NPLs);
- Concentration of the total loan portfolio in a single sector.

III. PROJECT DESCRIPTION

A. Project Components

24. Project Scope and Phasing. This Project aims to support the Regional Infrastructure Development Fund (RIDF) as a retail domestic financial intermediary in Indonesia. Managed by PT. SMI, RIDF will increase subnational governments' access to finance for basic environmental, productive and social infrastructure. GoI has indicated its preference for a phased approach for RIDF, to enable refinement of RIDF's business model after the initial years of operation. Under the first phase, the World Bank and AIIB would each provide financing of US\$ 100 million, for a combined total of US\$ 200 million for half of the initial capital of RIDF. Subsequently, it is anticipated that additional financing of US\$ 300 million would be sought for a second phase, so that the aggregate total borrowing for RIDF would be US\$ 500 million. This PAD focuses on the first phase of RIDF.

25. The Project will be structured with two components as described below.

Component 1: Capital Support for RIDF (US\$ 400 million; comprising US\$ 100 million of IBRD financing, US\$ 100 million of AIIB co-financing, and US\$ 200 million of Borrower equity contribution)

26. This component will provide loans to participating subnational governments in Indonesia for selected infrastructure subprojects. Up to US\$ 400 million will be available for PT. SMI to use for RIDF, providing senior debt to subnational governments in Indonesia for economically viable infrastructure projects. The main features of RIDF's proposed design are summarized in this section; further details are provided in Annex 2 on the detailed Project description, and Annex 3 on implementation arrangements.

27. Capital Structure. The Project will provide funding to PT. SMI to capitalize RIDF through a mix of debt and equity. The debt component will be provided as World Bank and AIIB co-financing channeled through a two-stage loan process: GoI (represented by MoF) will borrow from the World Bank and AIIB in foreign currency and on-lend the proceeds to PT. SMI in IDR. Under this arrangement, MoF will assume the exchange rate risk. The subsidiary loans from MoF to PT. SMI will be priced to cover the exchange rate risk as per GoI regulations for lending to SOEs. MoF will apply GoI's standard interest rate for such subsidiary loans – applicable to all state-owned enterprises – which is the equivalent of the prevailing coupon rate of the 20-year SUN (Indonesian government bond), currently set at 8.25 percent¹³.

28. Matching equity contributions from GoI will be funded from cash that is currently available on PT. SMI's balance sheet. The source of this equity contribution includes asset transfers from the former *Pusat Investasi Pemerintah* (PIP), whose mandate for lending to

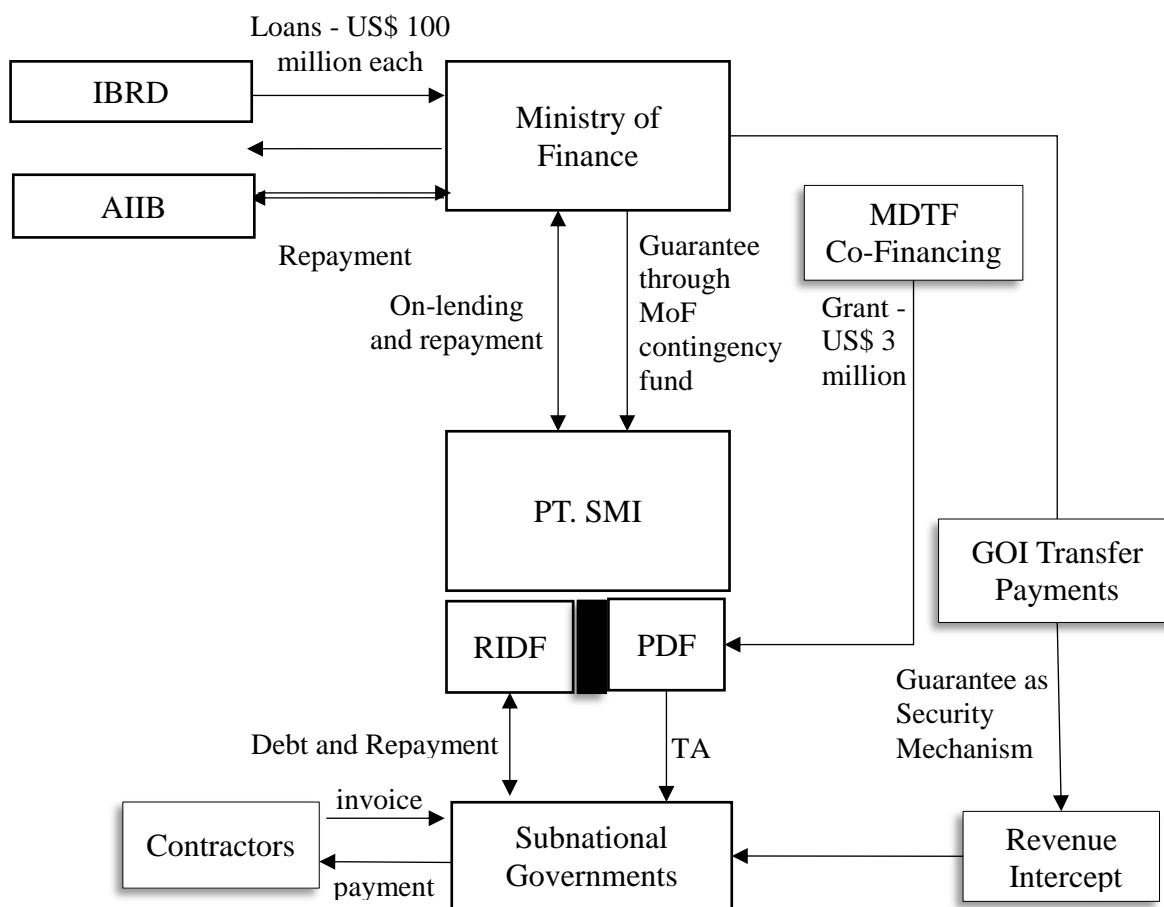
¹³ MoF has the ability to charge PT. SMI a lower rate for this project, as provided for in Ministerial Regulation No. 40/PMK.05/2015, since municipal lending is classified as a special assignment (“*penugasan*”) to PT. SMI from MoF.

subnational governments is now subsumed within PT. SMI. Additional equity contributions would come in the form of new capital injections from GoI, as needed.

29. Pricing Policy and Cost of Funds. RIDF will adopt a ‘cost plus’ pricing policy. The interest rate for RIDF loans to subnational governments will be based on the yield of the SUN corresponding to the tenor of the subproject loan in question, plus a margin of 75 basis points. As the lowest benchmark SUN rate is that of the 20-year SUN, currently 8.25 percent, this would imply an RIDF lending rate of at least nine percent. This would be attractive for subnational governments: available funding for subnational governments in Indonesia has ranged from 9.5 percent under the previous PIP, to up to 11 percent under other commercial/institutional funds (though these have a very limited interest in lending to subnational governments). Moreover, commercial loans are short term (one to five years) and only available for commercially attractive projects.

30. Figure 2 illustrates the proposed arrangements for the flow of funds under this Project, which are described in further detail in Annex 3 on implementation arrangements.

Figure 2: RIDF Flow of Funds



31. Eligibility of Subprojects. RIDF will fund subprojects under an open menu of environmental, social and productive infrastructure that fall within the clear jurisdictional

responsibility of subnational governments under Indonesia’s decentralized system. Subprojects must also be economically viable and have clear development and poverty reduction impacts. Eligible sectors include water supply, sanitation, sewerage, drainage, solid waste, urban transport including roads, low-income housing, slum upgrading, and primary healthcare and education facilities.

32. Detailed operating procedures covering sector eligibility and associated technical, economic, financial, social and environmental appraisal criteria are included in RIDF’s Operations Manual (OM). Important eligibility conditions for subprojects include, amongst others: (i) all necessary statutory clearances have been obtained, and are fully documented in the Project evaluation report; (ii) compliance with environmental and social standards as set forth in RIDF’s Environmental and Social Management Framework (ESMF); (iii) use of the most appropriate and cost-effective technology and technical norms and specifications. GoI’s eligibility criteria for subnational borrowing are summarized in Table 1.

Table 1: Eligibility Criteria for RIDF’s Subnational Government Borrowers, per GoI Regulations

1	Infrastructure to be financed is public infrastructure that is most needed (priority) and is contained in the RPJMD.
2	Approval of the relevant legislature (DPRD) at the subnational-level.
3	Subnational government is not in arrears, whether with SLA or other loan sources.
4	DSCR of at least 2.5 times (as stipulated in PP No. 30/2011).
5	Loan amount should not exceed 75 percent of the accumulated general revenue amount in the APBD of the previous fiscal year.
6	Current fiscal year APBD deficit, if any, is within the limits prescribed by applicable regulations.
7	Audit results from BPK (supreme audit institution) from each of the last three years should be at least WDP (qualified opinion) or better.
8	A recommendation (“ <i>pertimbangan</i> ”) from the Ministry of Home Affairs based on a structural review of the subnational government’s annual budget (APBD).

33. Framework Approach and Subproject Pipeline. This Project has been designed and appraised under a ‘framework approach’, where the assessment of Project readiness requires that corporate systems, regulations and detailed operating procedures have been developed and put in place. At appraisal, the Project did not include a definitive list of subproject investments. Nonetheless, the Project preparation process has identified and pre-screened a list of potential subprojects that would be subject to full appraisal as per RIDF operating procedures during Project implementation. From the market assessment, the list contains 18 subprojects spread across 10 subnational governments throughout Indonesia, with an estimated investment value of US\$ 568 million (see Table 2 below). Subnational governments that are requesting support from PT. SMI have proposed 32 subprojects with an estimated value of around US\$ 454 million. The investment value of individual subprojects ranges between US\$ 10 and 90 million. This list of potential subprojects has not yet been fully appraised by PT. SMI, and so not all subprojects and subnational governments that have applied for RIDF financing will necessarily pass the complete set of assessments and screening that will be undertaken by PT. SMI. Annex 6 provides more details on the effective demand to borrow, and the potential subproject pipeline.

34. Lending Policies. RIDF's core lending policies will include the following:
- Appraisal of subprojects on the basis of economic rather than financial viability;
 - Use of 'cost plus' pricing (i.e. to cover the cost of capital, operating expenses and anticipated risk);
 - Medium to long-term tenor loans (e.g. minimum tenor of five years, up to a maximum of 10 years);
 - Loans will be general obligations of the subnational governments with the status of senior debt;
 - Rigorous provisioning norms consistent with OJK regulations; and
 - A clear system of prudential norms.
35. The set of recommended prudential norms for RIDF include:
- Maximum loan value of 90 percent of the total cost of a subproject¹⁴;
 - Single borrower limit of not more than 15 percent of RIDF's total assets;
 - Single subproject limit of not more than 10 percent of RIDF's total assets;
 - Single sector limit of not more than 35 percent of RIDF's total assets.

Table 2: Summary of Potential Subprojects with a High Level of Readiness, by Subnational Government

No	Subnational Government	Estimated Investment (US\$ millions)	Sectors
1	Balikpapan (City)	314	Roads and Drainage
2	Semarang (City)	71	Roads
3	Sorong (City)	58	Roads and Drainage
4	Batam (City)	42	Roads
5	Sidoarjo (Regency)	28	Water supply
6	Bogor (City)	25	Water supply and sewerage
7	Denpasar (City)	14	Hospital
8	Gresik (Regency)	7	Roads
9	Yogyakarta (City)	5	Drainage
10	West Lombok (Regency)	4	Water Supply
	Total	568	

36. Security Structure. Law 33/2014 on Fiscal Balance stipulates that if a subnational government fails to make a loan repayment, then this obligation can be accounted for against the DAU (general purpose grant) or DBH (revenue sharing grant) transfers that the subnational government is otherwise entitled to. The detailed procedures for such intercepts are described in the Government Regulation PP No. 30/2011 (Article 64), and the Ministerial Regulation PMK 47/07/2011. Therefore, a security structure has been designed for RIDF that is a post-default

¹⁴ The total cost of a subproject comprises not only construction costs, but also other costs such as subproject preparation, design, supervision, goods, and land (if applicable). Therefore, a subproject loan could finance 100 percent of construction costs, within the overall limit of the total subproject cost.

guarantee with intercept mechanism (see Figure A2.1 in Annex 2), that would provide protection to PT. SMI in the case of RIDF borrower default. Under this structure, all RIDF lending would be covered by a full guarantee from MoF in the case of default by a subnational government. A contingency fund will be set up at MoF for this purpose. Upon the triggering of the guarantee, MoF would transfer the necessary amount from the contingency fund to PT. SMI to cover the value of the executed guarantee. MoF would then intercept intergovernmental transfers to the subnational government in question, to replenish the contingency fund.

37. To facilitate this security mechanism for RIDF, MoF is issuing three ministerial regulations (PMKs). The first regulation stipulates a special assignment and guarantee to PT.SMI in relation to its lending to subnational governments. This regulation addresses the guarantee scheme, eligibility criteria for borrowing from RIDF, types of infrastructure funded, pricing policy, risk mitigation and monitoring, etc. The second regulation relates to the procedures for intercepts of the DAU and DBH transfers to subnational governments, and constitutes a revision of the existing PMK No. 47/07/2011 on intercepts of intergovernmental transfers in the case of subnational default. The third regulation specifies the procedures for creating and managing the contingency fund at MoF, and is thus for MoF's internal use.

Component 2: RIDF Project Development Facility (US\$ 6 million; comprising US\$ 3 million of grant financing from the IDSUN MDTF, and US\$ 3 million of Borrower contribution)

38. This component will provide support for subnational governments in carrying out subproject identification and preparation, including, but not limited to, feasibility studies, detailed engineering designs, environmental and social safeguard assessments, advisory services on financial management and procurement, and training. Under this component, a Project Development Facility (PDF) will be established as part of this Project, with the objective of building a subproject pipeline for RIDF. The PDF will provide financing for the preparation of subprojects that are assessed to be realistic, feasible and within the domain of RIDF funding. PDF support will help ensure that subprojects are consistent with the technical, financial, economic, social and environmental appraisal standards of RIDF. It will also help to lower the costs of project preparation for subnational governments, provide expert assistance in standardizing designs, and produce a pipeline of financeable subprojects for RIDF.

39. The activities eligible for PDF support are:
- (i) project identification and preliminary structuring;
 - (ii) project preparation studies, including feasibility studies, detailed engineering designs, and safeguards instruments;
 - (iii) design and supervision assistance;
 - (iv) advisory services related to financial management, environmental and social assessments, etc.;
 - (v) preparation of procurement and contract documents; and
 - (vi) training for subnational governments on the above.

40. These activities are consistent with good practice cases of similar facilities in India, the Philippines and South Africa. These facilities are typically revolving funds financed by the

respective government and international agencies. They provide assistance in the areas of undertaking pre-feasibility studies, environmental and social impact assessments, project documentation and preparation of detailed project reports.

41. To avoid potential conflicts of interest, the PDF will be housed under a separate business unit within PT. SMI, specifically under the Project Development Division. This division of PT. SMI already undertakes activities similar to those proposed for the PDF, which would become an additional activity under the same directorial oversight. The PDF would naturally adopt the same eligibility and compliance standards of RIDF.

42. Half of the initial funding for the PDF, in the amount of US\$ 3 million, is being provided by the Indonesia Sustainable Urbanization (IDSUN) MDTF. The Administration Agreement for the IDSUN MDTF was signed in May 2016. The Bank will channel the grant from the IDSUN MDTF under a Recipient-executed Trust Fund (RETF) arrangement, which is being processed as part of this Project. In the longer-term, options for ensuring financial sustainability of the PDF include the possibility of a small spread on all RIDF loans with proceeds earmarked for replenishment of the PDF.

B. Project Cost and Financing

43. The estimated Project cost is US\$ 406 million, with a blend of World Bank financing, AIIB co-financing, Borrower equity contribution, and RETF grant, as outlined in Table 3 below.

Table 3: Project Cost and Financing, US\$ millions

Project Components	Total Project Cost	World Bank Financing	AIIB Co-financing	GoI Contribution	IDSUN RETF Grant
1. Capital Support for RIDF	400	100	100	200	-
2. RIDF Project Development Facility	6	-	-	3	3
Total by Source	406	100	100	203	3

C. Lessons Learned and Reflected in the Project Design

44. The Project design for RIDF has benefited from lessons learned from Indonesia's domestic experience with the financing of infrastructure by subnational governments, as well as from international experience with financial intermediary (FI) lending for subnational infrastructure.

45. Lessons from Domestic Experience. **The direct implementation of subnational infrastructure financing instruments or vehicles by MoF is likely to achieve limited success due to a number of inherent governmental constraints.** RDI, RDA and SLA were largely implemented by directly MoF. All three were characterized by questionable accountability and political interference in lending decisions; the lack of professional credit appraisal; the absence

of adequate security structures; and the inability to build capital and implement a financially sustainable model for subnational lending. In light of this experience, this Project has been designed based on the clear autonomy that PT. SMI enjoys, where RIDF's lending operations will be based on objective appraisal criteria, and backed by an appropriate security structure.

46. **Supply-driven lending results in poor performance and weak ownership at the subnational level.** Particularly for the RDA and SLA instruments, borrowing was largely supply-driven from MoF or other central government agencies, with the resulting assets and liabilities later transferred to subnational governments which had little ownership or incentive to ensure sound performance. RIDF has been designed to respond to actual demand from subnational governments, with a PDF that will ensure adequate preparation and ownership during the preparation phase of each subproject.

47. **Subnational infrastructure financing needs to take full account of the range of possible risks;** these include end-borrower repayment capacities as well as exogenous factors such as exchange rate movements. In the case of obligations related to SLAs linked to external foreign currency borrowing, the exchange rate shock from the 1997 financial crisis severely eroded repayment capacity. Subnational government revenues, and correspondingly repayment capacity, did not begin to strengthen until after 2006 as fiscal transfers significantly buoyed subnational government finances. The risks to RIDF are addressed through the full set of criteria for subproject appraisal, the prudential norms for RIDF's portfolio, and the assumption of exchange rate risk by MoF through the on-lending arrangements for the World Bank and AIIB loans.

48. Lessons from International Experience. The practice of FI lending for subnational infrastructure has a long and mixed track record in developing countries. As part of Project preparation, a wide range of experiences was examined, including those in Colombia (FINDETER), India (TNUDF), Morocco (FEC), the Philippines (LOGOFIND), South Africa (INCA), and Vietnam (HIFU).

49. **Autonomy and 'arms-length' governance structures are disproportionately associated with FI financial sustainability and strong performance.** FIs structured as SOEs or mixed-equity companies with independent boards and autonomy of credit decisions perform better than FIs that are within government and subject to political interference in credit decisions. FIs set up under limited liability structures with the ability to build capital are also more likely to achieve financial sustainability and leverage market-based sources of capital than FIs that are 'on-budget' vehicles of government. Moreover, the financial sustainability of FIs is on aggregate associated with market-based or cost-plus pricing of debt, rather than heavily subsidized or grant-based financing.

50. **On aggregate, FIs have not had a strong track record delivering on significant sector or institutional reform or capacity building objectives.** More generally, FIs have been unable to overcome fundamental inefficiencies in intergovernmental fiscal frameworks (e.g. inadequate revenue authority at the local level, small or volatile transfer revenues, poor subnational indebtedness frameworks, etc.). Successful FIs have focused more narrowly on expanding access to credit for critical infrastructure, with parallel advisory and lending vehicles

addressing reform challenges. At the same time, the performance of FIs is strongly enhanced by mechanisms that actively support subnational governments in project preparation. Given these lessons, RIDF has been designed as an FI with the specific objective of expanding access to infrastructure finance, accompanied by a PDF for project preparation, and without overreaching ambitions to achieve broader sectoral reform.

51. **In developing the proposed design for RIDF, a few alternatives were considered and rejected.** One such option was for a wholesale facility that would act as a second-tier lender to commercial banks that would be the first-tier lenders to subnational governments. The wholesale model has the advantage of credit risks being shifted away from the FI to the participating commercial banks. However, wholesale financing would imply that the FI itself takes on the commercial bank credit risks. In the case where banks do not place their own capital at risk, the basic policy objective of crowding-in private financing may be difficult to achieve. Furthermore, if the wholesale credit is subsidized, this would tend to squeeze out commercial banks not participating in the scheme.

52. A pure credit enhancement model was also considered, and would have offered the potential of drawing in private capital without needing to set up RIDF. However, a number of factors suggested that this would not be the most effective way forward. First, it is unlikely that a credit enhancement entity alone would be enough to encourage banks and other financial institutions to give long tenor loans to subnational governments, given the maturity mismatch that would arise from the short-term nature of most bank deposits in Indonesia. Second, there has been limited international experience with pure guarantee facilities that have leveraged private finance. Moreover, GoI has already transferred PIP lending assets to PT. SMI, giving PT. SMI the clear mandate to function as a lender to subnational governments, and ultimately to raise resources from the domestic capital market for such lending.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

53. PT. SMI will be the implementing agency for RIDF. As a state-owned enterprise (SOE) that is solely owned by the GoI through MoF, PT. SMI operates under a limited liability structure with the ability to build capital, leverage and blend market financing, and invest in high quality technical and financial capacity. It has an independent Board and the mandate to make independent appraisal and credit decisions.

54. Since its inception in 2009, PT. SMI's basic objective has been to invest in infrastructure financing institutions or otherwise provide funds for infrastructure financing in Indonesia. More recently, in February 2015 MoF decided to dissolve PIP and transfer its assets to PT. SMI. This move gave PT. SMI a clear mandate for lending to subnational governments for infrastructure. GoI's medium-term plan is to develop a domestic development bank: *Lembaga Pembiayaan Pembangunan Indonesia* (LPPI); although the details and roadmap for the development of LPPI have not yet been specified, MoF has indicated that PT. SMI will be the 'embryo' for the future LPPI. A detailed institutional assessment of PT. SMI is provided in Annex 7.

55. The Directorate General of Budget Financing and Risk Management of MoF, will have the primary responsibility for managing the World Bank and AIIB loans for RIDF, as well as overseeing the security mechanism for RIDF. The Directorate General of Treasury will be responsible for the subsidiary loan agreements (SLAs) between MoF and PT. SMI, and for processing and transferring loan funds to PT. SMI. Drawdowns from the World Bank and AIIB loans will be made on the basis of requests from PT. SMI to MoF, and hence from MoF to the World Bank (see Figure 2 above).

56. RIDF's lending policies will be based on all relevant regulations on subnational borrowing, including those issued by MoF and MoHA, as well as technical guidelines issued by line ministries. Borrowing subnational governments will be subject to the same set of regulations, as well as existing regular audits by BPK, Indonesia's supreme audit institution.

57. An Operations Manual (OM) for RIDF has been developed by PT. SMI and MoF. The OM provides detailed operating policies and procedures that will be used for RIDF to process, appraise, provide, and monitor loans to subnational governments; undertake procurement for meeting its own requirements and for also overseeing compliance and monitoring performance of the procurement undertaken by the subnational governments; implement environmental and social safeguards; and for general financial management (planning, budgeting, accounting and financial reporting). The OM also includes the operating policies and procedures of the PDF.

58. To ensure avoidance of potential conflicts of interest among different functions within PT. SMI (e.g. project advisory, project equity, and debt financing to subnational governments and others), mechanisms are in place to ensure sufficient independence and separation of the project development and project financing functions. Teams working on policy reform and project development will be discrete and separated from the teams involved in project finance operations, reporting to separate top-level directors. Within PT. SMI, RIDF will be housed under the Directorate for Financing and Investment, while the PDF will be under the Project Development and Advisory Directorate.

59. In terms of implementation arrangements between the World Bank and AIIB, as reflected in the Co-financing Framework Agreement between the two institutions, the World Bank will be the lead co-financier. Accordingly, the World Bank will perform all the usual services associated with Project implementation, which includes, among others, environmental and social safeguards, procurement, financial management, disbursement, and investigations if needed. The World Bank will also be the main point of communication for GoI and PT. SMI during Project implementation.

B. Results Monitoring and Evaluation

60. The Project's Results Framework provides the basis for measuring progress towards the Project's objectives. It includes the PDO-level outcome indicators related to increasing access to infrastructure finance at the subnational level, and the financial performance and sustainability of RIDF, as well as component-specific intermediate indicators, with baselines and targets for each over the life of the Project.

61. Two types of monitoring and evaluation activities will be carried out during Project implementation: regular monitoring, and a Project mid-term review (MTR). PT. SMI will be principally responsible for Project monitoring, including reporting on the outcome and intermediate indicators on a regular basis. An independent impact evaluation will be conducted at the completion of the Project to assess the achievement of the final Project results. RIDF will also be closely monitored by the Ministry of Finance. The World Bank team will conduct semi-annual implementation support missions in close coordination with PT. SMI. In addition to the summary information that has been provided in this section, a more detailed description of this Project's institutional and implementation arrangements is given in Annex 3.

C. Sustainability

62. The core of sustainability for this Project is for RIDF to be financially viable. RIDF's basic financial sustainability requires pricing of its loans at a level that is affordable and attractive to subnational governments, while also covering its costs plus a margin to provide a reasonable return. More broadly, PT. SMI's independent governance structure and professional management capacity will provide the foundation for successful operation of RIDF. GoI's mandate to PT. SMI to spearhead lending to subnational governments also ensures policy-level support to enable the regulatory environment within which RIDF will operate.

63. In the medium term, as RIDF operations expand, its sustainability will depend on the evolution of the broader regulatory framework, the deepening of the debt market, and RIDF's own performance as a lender of significance for subnational governments. With a strong capital base and credit history, PT. SMI could raise resources from the domestic debt market, through both securitization and fresh bond issuance. From a market perspective, construction risks would have been overcome, and with a strong security mechanism, the RIDF loan assets would provide competitive, long-term yields for investors such as pension and insurance funds. Apart from securitization, subnational government borrowing demands could be pooled together (thereby reducing transaction costs and risks) and offered to the debt market based on ratings and the security provided. To rationalize the regulatory framework, GoI could also take steps to phase out the sovereign guarantee, and replace it with subnational level security mechanisms such as escrows and debt service reserve funds.

64. Options for ensuring the financial sustainability of the PDF include a small spread on all RIDF loans with proceeds earmarked for the recapitalization of the PDF. More broadly, strengthening the enabling environment for subnational borrowing, and related capacity building for central and subnational government officials, will support the long-term sustainability of RIDF.

V. KEY RISKS AND MITIGATION MEASURES

A. Overall Risk Rating and Explanation of Key Risks

65. The proposed operation is considered to have a substantial level of risk overall. Eight main types of risk have been identified: (a) stakeholder and political/governance risk at the local level; (b) macroeconomic risk; (c) regulatory risk in the sector; (d) Project framework approach

and pipeline risk; (e) credit risk; (f) PT.SMI institutional capacity risk; (g) environmental and social management risk; and (h) climate and disaster risk.

66. Stakeholder and Political/Governance Risk at the Local Level. Substantial risks may arise from competing interests at the local level, which may result in delays to individual subprojects. For example, subnational government borrowing requires approval from local legislatures. PT. SMI will develop an active outreach and communication campaign to local officials and legislators on the advantages and obligations associated with RIDF borrowing.

67. Macroeconomic Risk. Sluggish global growth and associated uncertainty have put pressure on Indonesia's economy. The Government has faced significant fiscal pressures since mid-2013. However, the macro policy framework is considered resilient to deterioration in external demand and conditions in the financial markets, so this risk is moderate. The Government has released 13 economic policy packages since September 2015 aimed at attracting foreign investment, revitalizing industry, facilitating trade and logistics, and enabling the creation of new businesses.

68. Regulatory Risk. A number of substantial sector-related policy risks exist, although the current regulatory environment allows for subnational borrowing consistent with the proposed RIDF model. First, there is a risk that subnational governments may encounter delays in obtaining the necessary concurrence from MoHA for their proposed borrowing. However, PT. SMI's recent experience with loans that were transferred from PIP has shown that it is able to liaise effectively with subnational governments and MoHA on this issue. Second, regulatory uncertainty exists related to the ongoing revisions of the Framework Law 33/2004 on the intergovernmental fiscal framework. Specifically, that hastily developed provisions on subnational borrowing could unduly constrain the market. The World Bank will work closely with MoF through policy advisory on the intergovernmental fiscal framework broadly, and specifically with respect to the intergovernmental borrowing framework, under the abovementioned *Decentralization that Delivers* PASA.

69. Project Framework Approach and Pipeline Risk. In terms of technical design, the Project uses a 'framework' approach, where specific subprojects are not confirmed before Project approval. There is a substantial risk of slow implementation and disbursement should the subproject pipeline turn out to be weak. Two strategies have been put in place to mitigate this risk. First, a comprehensive assessment of demand for RIDF has been undertaken by both the World Bank and PT. SMI. Interactions with several subnational governments have revealed many potential subprojects, with investment needs of around US\$ 1 billion (see Annex 6). The demand from subnational governments to borrow for infrastructure investment has been clearly demonstrated, and is assessed to be strong. Second, as part of the Project, the PDF unit within PT.SMI will actively engage with subnational governments to help them prepare subprojects. Grant funding for the PDF will enable the development of a strong subproject pipeline.

70. Credit Risk. A substantial risk exists that subnational governments will fail to honor repayment commitments to RIDF. The Project design mitigates this risk through two concurrent strategies. First, the design of the proposed RIDF within PT. SMI—an SOE with an independent board and governance framework—will enable strong appraisal standards and a clear business

orientation. Second, the security mechanism for RIDF will involve an intercept of central government transfers to subnational governments.

71. PT. SMI Institutional Capacity Risk. The RIDF business model is ambitious, involving an ‘open menu’ lending approach across multiple sectors. This will require considerable build-up in the technical, financial, economic, social and environmental management capacity of PT. SMI. This risk is moderate, as PT. SMI has already initiated efforts to build up its management and technical capacity.

72. Environmental and Social Management Risk. The Project framework approach, broad sector menu of eligible subprojects, local level execution and national geographical scope will create substantial environmental and social management risks. A range of mitigation measures will be implemented, including: (i) significant buildup of PT. SMI’s environmental and social management capacity as means to review, supervise and support subnational government Project planning and implementation; and (ii) periodic outreach to subnational governments to build capacity and orient local officials to environmental and social management guidelines for RIDF lending.

73. Climate and Disaster Risk. Individual subprojects may face these risks, depending on the nature and location of each subproject. The existing system of environmental assessment in Indonesia does provide for the analysis and mitigation of such risks. Standard technical guidance on the evaluation of major environmental impacts includes analysis of the risks of natural disasters for areas in or near sources of such risk. This is also reflected in relevant government regulations; for example, Government Regulation 64/2010, on mitigating disaster risks in coastal areas and small islands, specifies the use of a range of structural and non-structural mitigation measures, including AMDAL and spatial plans as appropriate. The assessment of climate and disaster risks for subprojects, and potential climate co-benefits, is described in Annex 9.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

74. **Economic Analysis.** The economic analysis of potential subprojects to be financed by RIDF can only be undertaken after the establishment of RIDF and as part of RIDF’s appraisal of such subprojects. Therefore, a framework approach has been developed for economic analysis at the subproject level. Specifically, it compares a “with project” scenario with a baseline “without project” scenario. For example, for a road subproject, the economic benefits expected would include reduced travel times and lower vehicle operating costs. The economic costs include construction costs, routine maintenance costs during operation, and environmental and social costs including externalities. The analysis of economic costs and benefits enables the estimation of the economic internal rate of return (EIRR) and the net present value (NPV) of the subproject, in monetary terms. Annex 8 illustrates the application of this methodology for two example subprojects: one for a road, and the other for a public market.

75. **Financial Analysis.** A financial analysis of RIDF has been undertaken based on a set of projected financial statements underpinned by assumptions about the first 10 years of RIDF’s

operations. Three different scenarios for drawdown of RIDF's equity and debt were evaluated: (i) equity drawn first followed by debt; (ii) equity and debt drawn in equal proportion; and (iii) debt drawn first followed by equity. In all the three drawdown scenarios, the debt service coverage ratio (DSCR) is well above 1, indicating a comfortable financial position in meeting debt service obligations. For the full set of projections, the third drawdown scenario (i.e. debt first and then equity) was used.

76. The projections estimate that RIDF's loan book would grow from US\$ 26 million in year 1 to as much as US\$ 791 million in year 5. Total assets are projected to reach more than US\$ 1.1 billion by year 10. Profits are driven by interest income, which starts off low in the first few years, before growing strongly in line with growth in the loan portfolio. Key financial ratios for RIDF— net profit ratio, return on assets, and return on equity – are all healthy throughout the period.

77. The sensitivity of the RIDF's financial performance was analyzed with respect to two key variables: the net interest margin, and non-performing loans (the NPL ratio). The results of this sensitivity analysis show that RIDF would be profitable with a net interest margin of at least 0.65 percentage points. Likewise, RIDF would be profitable so long as the NPL ratio remains below 15 percent. A more detailed discussion of the economic and financial analysis of the proposed Project can be found in Annex 8.

B. Technical

78. RIDF's core design as a retail lending operation has been assessed as being the most appropriate solution for addressing the needs of subnational governments for long-term infrastructure financing of economically viable subprojects. RIDF will complement the market for subnational borrowing, which currently lacks options for medium to long-term financing. In the Indonesian context, the key policy challenge is to institutionalize municipal lending through RIDF such that as the Indonesian debt market matures, PT. SMI would be able to raise domestic finance based on a rating of RIDF assets, earnings, and the security mechanisms available to reduce risks. In this way, RIDF is expected to crowd in market finance in the medium-term that would enlarge the overall supply of credit for subnational governments. More broadly, the Project preparation process has enabled a broadening and deepening of the World Bank's dialogue with various GoI counterparts (including MoF, MoHA and Bappenas) on strengthening the enabling environment for subnational borrowing, and related capacity building for central and subnational government officials, that will support the sustainability of the Project.

79. Subproject investments will be designed and appraised on the basis of Indonesian standards, in line with the relevant technical guidelines issued by line ministries/agencies. International standards may be adopted in specific instances where Indonesian standards are not available. Requirements in relation to financial management, procurement and safeguards for RIDF's operations overall, and the execution of individual subprojects, are contained in the Project Operations Manual (OM). These arrangements are summarized below and described further in Annex 3.

80. PT. SMI has been assessed to be a financially strong institution (see also the section above and Annex 3 on institutional arrangements, and Annex 7 on the financial and institutional assessment of PT. SMI). PT. SMI has good capacity overall, and where specific expertise is lacking, such as in safeguards, it is actively building the necessary capacity and recruiting additional specialist staff that will enable it to implement all required activities under RIDF. The Project design incorporates key areas of guidance provided by OP/BP 10.00, and includes a plan for implementation support (see Annex 3) for RIDF.

C. Financial Management

81. A Financial Management Assessment (FMA) has been conducted as part of the Fiduciary Assessment of the Project. The FMA assessed the adequacy of the financial management system of the implementing agency, PT. SMI, to produce timely, relevant and reliable financial information on Project activities, and to ensure the accounting systems for Project expenditures and underlying internal controls are adequate to meet fiduciary objectives, and allow the World Bank to monitor compliance with agreed implementation procedures and appraise progress towards these objectives.

82. The financial management (FM) risk is assessed as being substantial before mitigation and moderate after mitigation. The Project's FM arrangements follow the government system at central and local government levels (for both World Bank and AIIB loans), and PT. SMI's procedures agreed by the World Bank (for the RETF) as reflected in the Project's Operations Manual (OM). The FMA has identified the main FM-related risk as being PT. SMI's limited experience in financing subprojects at the subnational government level. To mitigate this risk, PT. SMI has prepared the Project OM which addresses RIDF's organization structure, the inclusion of the Project budget into the DIPA of MoF, guidelines for the management of funds by subnational governments, the funds flow mechanism, IFR preparation and disbursement mechanism, and internal and external audit arrangements. During Project implementation, PT. SMI will work with MoF on regular coordination with all Project stakeholders. The Bank will assist and provide support to PT. SMI, including providing training related to financial management, procurement, and Project monitoring and supervision.

83. Disbursement arrangements. The applicable disbursement methods are Advance and Reimbursement. For the loans from the World Bank and AIIB, a designated account (DA) under the name of PT. SMI and denominated in IDR will be opened at a government-owned or commercial bank acceptable to the World Bank. Advances from the World Bank and AIIB will be deposited in this DA and will be used solely to finance eligible expenditures under Component 1 of the Project. For the RETF, a DA under the name of PT. SMI and denominated in US\$ will also be opened at a government-owned or commercial bank acceptable to the World Bank. This DA will be used for financing eligible expenditures under Component 2 of the Project. Both DAs will be segregated accounts with fluctuated ceiling. Disbursement arrangements for the Project are reflected in the OM and have been agreed with the World Bank. Applications for the replenishment of the DA advance maybe submitted through quarterly IFRs which consist of: (i) DA Activity Statement; (ii) Statement of Expenditures under the World Bank's prior review and non-prior review; (iii) Project Cash Forecast for the next six-month period; and (iv) Project Sources and Uses of Funds.

D. Procurement

84. Procurement of Goods, Works, Non-Consultant Services and Consultant Services by PT. SMI for its own requirements and by subnational governments as beneficiaries under the sub-loans, shall be governed by the World Bank's Procurement and Consultant Guidelines and the provisions of the Financing Agreement. The bulk of the procurement by value and number of contracts under the Project is expected to constitute procurement of works and goods to be

undertaken by the subnational governments as beneficiaries of the sub-loans. PT. SMI will be responsible for carrying out the procurement for its own requirements, as well as overseeing compliance and monitoring the performance of procurement undertaken by the subnational governments under the sub-loans. Assessment of PT. SMI's procurement capacity indicates that it has limited previous experience in procurement for Bank-financed projects. Similarly, the future beneficiaries of the sub-loans, i.e. subnational governments, are unlikely to have experience in Bank-financed procurement. The Operations Manual (OM) prepared by PT. SMI and approved by the Bank sets out the applicable procurement procedures, and the roles and responsibilities of PT. SMI and the beneficiaries of the sub-loans.

85. The procurement risk under the Project is considered to be high. The World Bank Integrity Vice Presidency (INT) recently completed investigations in sectors relevant to this Project. Investigations found indicators of collusion, corruption, and various acts of fraud during procurement and contract implementation of several contracts financed under two other projects. Accordingly, appropriate strengthening measures have been identified to mitigate this risk, as mentioned above. Further details of the procurement arrangements and mitigation measures are provided in Annex 3.

E. Social (including Safeguards)

86. The types of infrastructure supported by Component 1 are expected to have significant benefits for local populations, but if development of this infrastructure is not well prepared and managed properly, potential negative social impacts may arise from involuntary land acquisition and resettlement. Infrastructure development may also limit community access to natural resources on which local livelihoods depend. As subprojects and eligible subnational governments are expected to be widely distributed across Indonesia, it is anticipated that some subprojects may also affect Indigenous Peoples. Therefore, OP 4.12 on Involuntary Resettlement and OP 4.10 on Indigenous Peoples are triggered.

87. An assessment of potential subprojects and subnational governments shows that many subprojects are infrastructure located in urban areas (see Annex 6). There is also the possibility that subprojects will be located across districts covering both urban and rural areas, as well as undeveloped areas. However, the exact location of subprojects is not yet known, and can only be determined during Project implementation. Therefore, the intensity of social impacts (positive and adverse) cannot be assessed at this stage.

88. Based on the indicated sizes of expected subproject investments, it is likely that there will be moderate to significant social impacts due to land acquisition. In cases of on-site redevelopment or expansion from past loans to subnational governments financed by PIP – such as the examples of hospitals in Karangasem (US\$ 3.5 million) and Solo (US\$ 3.1 million), and public markets in Karangasem (US\$ 3.8 million) and Temanggung (US\$ 7.4 million) – social issues may typically arise during construction due to the temporary relocation of traders and services in the hospitals as well as disturbances during construction.

89. PT. SMI has prepared a single Environmental and Social Management Framework (ESMF) for RIDF (Component 1) and the PDF (Component 2). The ESMF includes a Land

Acquisition and Resettlement Policy Framework (LARPF), Process Framework (PF), and an Indigenous Peoples Planning Framework (IPPF), as well as Grievance Redress Mechanisms and Disclosures and arrangements for monitoring the implementation of social safeguards instruments (such as a Resettlement Plan, a Plan of Action, and an Indigenous Peoples Plan). The draft ESMF was disclosed on PT. SMI's website on June 15, 2016, and disclosed through the World Bank's Infoshop on July 18, 2016. Consultations with stakeholders on the draft ESMF were held on June 21 and 22, 2016. The final version of the ESMF was disclosed on PT. SMI's website and the Infoshop on November 3, 2016. The ESMF will accompany the Operations Manual that will be used by both RIDF and the PDF.

90. The ESMF was developed on the basis of PT. SMI's current Environmental and Social Management System (ESMS) and Environmental and Social Standards (ESS). The current ESMS has adopted national laws and regulations pertaining to land acquisition and environmental management, and applies to projects funded from PT. SMI's own financial resources. Recently, PT. SMI has also adopted 10 ESSs that reflect national laws and regulations as well as some international standards, which apply to projects financed by multilateral agencies. PT. SMI currently uses both the ESMS and ESS in its operations, mainly PPP projects, whereby social (and environmental) safeguards due diligence is undertaken once a subproject is defined as eligible for financing based on the financial and investment assessments. A Corrective Action Plan to meet ESMS requirements is prepared based on gaps identified in the due diligence assessment, and its implementation is covenanted in the loan agreement between PT. SMI and the borrower. In future, once RIDF is established, PT. SMI will use the ESMF for the operations of RIDF and the PDF, regardless of the financing sources that support the RIDF and PDF operations.

91. For the preparation and implementation of each RIDF subproject, the subnational government in question will be responsible for preparing the social safeguards instruments such as a Resettlement Plan (RP), a Plan of Action, and/or IPP, as relevant. The Directorate General of Budget Financing and Risk Management of MoF is responsible for monitoring and evaluation of PT. SMI's performance in implementing the Project, including adherence to the requirements specified in the ESMF. In addition, PT. SMI will ensure adequate citizen engagement through adequate information disclosure, regular impact evaluations, as well as a complaint handling mechanism.

92. PT. SMI's existing social safeguards staffing and capacity will gradually increase to manage the expected growth in business requirements arising from the pipeline of RIDF subprojects (including PDF operations). PT. SMI has established an Environmental and Social Safeguards and Business Continuity Management Unit (ESSBCM) under the Directorate of Risk Management. This unit will support and oversee the overall environmental and social safeguards management for PT. SMI, including for RIDF and the PDF. At present it has a senior environmental expert and a junior environmental specialist as well as a social safeguards specialist. Currently, PT. SMI relies heavily on social safeguards consultants and experts from a pool of advisors who work mostly part time. PT. SMI's business plan specifies that in the next five years, there will be a manager for environmental and social safeguards, and at least one full-time senior social safeguards expert. PT. SMI will hire consulting firms as needed to help with screening and due diligence for proposed subprojects, and guiding subnational governments in

preparing and implementing social safeguards instruments. Specific in-house as well as outside trainings will be provided to the environmental and social safeguards experts. In addition, the safeguards experts of the ESSBCM unit will provide training on social and environmental safeguards management for subnational government staff.

93. **Citizen Engagement.** The RIDF Project design includes a number of features to ensure meaningful participation of stakeholders at the local level, to strengthen governance and accountability in the planning and implementation of subprojects. During the planning phase of each subproject, the responsible subnational government will ensure citizen participation through public discussions, consultations, and information disclosure, including through consultations related to environmental and social safeguards. Subproject proposals will be reviewed to ensure coherence with the existing local development plan of the subnational government. As part of the implementation support plan for RIDF, the Project will develop and deliver hands-on learning on effective citizen engagement for PT, SMI and subnational governments. During Project implementation, subproject-specific complaints received and resolved by subnational governments will be monitored; this has been included as an intermediate indicator in the Project's results framework. Subnational governments across Indonesia typically have SMS or web-based systems for receiving complaints, to which subnational governments commit to certain timeframes for resolving each complaint received. Project monitoring will also involve surveys to measure beneficiaries' satisfaction with subproject implementation. Survey techniques that have been applied successfully in Indonesia, such as Interactive Voice Response (IVR) and/or SMS-based surveys that target mobile phone users in subproject locations, would be used where feasible.

94. **Gender.** During implementation, RIDF will ensure that the planning of subprojects is gender-informed and presents no clear risks vis-à-vis gender equity. In particular, consultations would include focus group discussions with women's groups, to adequately take into account their specific needs and perspectives. The Project design also integrates consideration of gender issues in the Project's Operations Manual, including approaches such as Gender-responsive Planning and Budgeting, and subproject evaluations disaggregated by gender, to support mainstreaming during implementation. The Project's implementation support activities will also expand training on gender awareness to Project stakeholders, by targeting local government officials and community groups.

F. Environment (including Safeguards)

95. The Project will finance environmental infrastructure investments such as water and sewage treatment plant, sanitary landfill, hazardous waste management facilities, hospital revitalization and urban slums improvement that will bring existent benefits for the surrounding communities. The Project is classified as Category FI because it involves investment of World Bank funds through a financial intermediary, in subprojects that may result in adverse environmental impacts. Potential adverse environmental impacts from subprojects mentioned above are mainly derived from physical construction activities (health and safety, traffic management, dust, noise, material transportation etc.), as well as from the operation stage such as poor hazardous waste management from hospital operations. In addition, the Project could also cause induced impacts such as a potential illegal logging from a new access road to a forest

area or natural habitats. These potential impacts of subprojects will range from medium to high, could be significant, diverse, and irreversible. There is also a possibility of cumulative impacts and other impacts related to linked activities funded by government or other donors, and potential impacts of ancillary facilities such as quarry operations. Therefore, safeguards policies on Environmental Assessment (OP/BP 4.01), Natural Habitats (OP/BP 4.04), Forests (OP/BP 4.36), Pest Management (OP 4.09), Physical Cultural Resources (OP/BP 4.11), and Safety of Dams (OP/BP 4.37) are triggered.

96. Given the nature of RIDF, analysis of the potential adverse environmental (and social) impacts, and devising appropriately detailed measures for mitigating those impacts is considered an output of the Project, rather than a prerequisite. Since it is neither possible nor appropriate to prepare conventional instruments (EA, RAP, IPPs) prior to appraisal, the ESMF has been prepared for use during Project implementation to address the requirements of OP/BP 4.01, 4.04, 4.36, 4.09, 4.11, 4.10, 4.12 and 4.37. The ESMF has been publicly consulted and is acceptable to the World Bank. Under the ESMF, each subproject will be screened to identify: (i) safeguards policies triggered, (ii) EA category, (iii) safeguards instruments and associated analyses to incorporate risk and impact minimization, mitigation measures and monitoring program. Based on the results of this screening, specific safeguards instruments for each subproject will be developed.

97. Key safeguards risks related to lack of capacity in preparing and implementing safeguards instruments, among both subnational governments and PT. SMI, have been identified. The most effective way to mitigate this risk is by providing close and intensive support and mentoring on safeguards implementation to PT. SMI. At the same time, subnational governments will receive substantial support from PT. SMI through the PDF mechanism. Ongoing monitoring and implementation support will be provided to PT. SMI to help ensure that subnational governments fulfill the requirements specified in the ESMF. This will include advice on aspects including the subproject screening process, TORs for safeguards documents (ESIA, LARAP), the appraisal methodology, and also gap filling between Indonesia's country systems and the World Bank's safeguards policies.

98. For the first five high-risk subprojects, the World Bank will conduct joint appraisal and review together with PT. SMI prior to subproject approval. If found to be necessary during Project implementation, this joint prior review approach could be extended to additional high-risk subprojects beyond the first five. As part of regular Bank supervision of Project safeguards implementation, for medium and low-risk projects the Bank will monitor RIDF's operations through post-review to ensure that the ESMF is consistently adhered to, and promptly initiate any corrective action as required. The full range of mitigation measures for safeguards risks are described in further detail in the Implementation Support Plan in Annex 4.

99. Building Climate Resilience. For physical infrastructure, including RIDF subprojects, considering future climate variability and change is critical to avoid "locking in" designs and features that are only suited to the current climate. While the costs of "building better" may entail a higher upfront cost today, the benefits may outweigh the costs in terms of avoided damage to the infrastructure and associated reductions in property damage, injuries, and loss of life. Therefore, wherever practical, subprojects should be designed and implemented so as to be

resilient to climate-related risks. A simple framework approach has been developed for climate and disaster risk screening at the subproject level, drawing on the World Bank's Climate and Disaster Risk Screening Tools.

G. World Bank Grievance Redress

100. Communities and individuals who believe that they are adversely affected by a World Bank supported Project may submit complaints to existing Project-level grievance redress mechanisms or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address Project-related concerns. Project affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of the World Bank's non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service, please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

Annex 1: Results Framework and Monitoring

Project Development Objectives

The project development objective (PDO) is to increase access to infrastructure finance at the subnational level through a financially sustainable financial intermediary.

These results are at Project Level

PDO Level Results Indicators and Monitoring Arrangements

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1	YR2	YR3	YR4	End Target			
<i>Increased access to infrastructure finance at the subnational level</i>											
Number of subnational governments receiving RIDF loans	<input type="checkbox"/>	Number	0	5	11	18	25	25	Annually	RIDF Annual Report	PT. SMI will calculate and report on these indicators as part of its annual report to RIDF stakeholders.
Average loan size approved by RIDF	<input type="checkbox"/>	IDR billions	0	≥100	≥120	≥150	≥150	≥150	Annually		
Average tenor of loans approved by RIDF	<input type="checkbox"/>	Years	0	5.0	6.5	8.0	8.0	8.0	Annually		
<i>Financial performance and sustainability of the financial intermediary (RIDF)</i>											
Return on RIDF assets	<input type="checkbox"/>	Percentage	0	≥1 percent	≥1 percent	≥1 percent	≥1 percent	≥1 percent	Annually	RIDF Annual Report	PT. SMI will calculate and report on these indicators as part of its annual report to RIDF stakeholders.
Non-performing loans (NPLs)	<input type="checkbox"/>	Percentage	0	<5 percent	<5 percent	<5 percent	<5 percent	<5 percent	Annually		
Proportion of the total loan portfolio concentrated in a single sector	<input type="checkbox"/>	Percentage	0	≤50 percent	≤45 percent	≤40 percent	≤40 percent	≤40 percent	Annually		

Intermediate Level Results Indicators and Monitoring Arrangements

Intermediate Results Indicators	Core	Unit of Measure	Baseline	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1	YR2	YR3	YR4	End			
<i>Component 1: Capital Support for RIDF</i>											
Amount of capital raised	<input type="checkbox"/>	US\$ millions	0	100	200	300	400	400	Annually	RIDF Annual Report	PT. SMI will calculate and report on these indicators as part of its annual report to RIDF stakeholders.
Number of subproject loans appraised	<input type="checkbox"/>	Number	0	≥5	≥15	≥25	≥40	≥40	Annually		
Percentage of subproject-specific complaints received that are addressed / followed-up by subnational governments	<input type="checkbox"/>	Percentage	0	80 percent	90 percent	100 percent	100 percent	100 percent	Annually	Subproject activity reports from subnational governments; complaints handling mechanisms at subnational government level.	Participating subnational governments will collect and report data to PT. SMI, which will in turn compile data to derive aggregate indicator values for RIDF as a whole.
<i>Component 2: RIDF Project Development Facility (PDF)</i>											
Number of subnational governments applying for RIDF Project Development Facility services	<input type="checkbox"/>	Number	0	≥5	≥15	≥30	≥40	≥40	Annually	RIDF Annual Report	PT. SMI will calculate and report on these indicators as part of its annual report to RIDF stakeholders.

Intermediate Results Indicators	Core	Unit of Measure	Baseline	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1	YR2	YR3	YR4	End			
Number of projects prepared with assistance from the RIDF Project Development Facility	<input type="checkbox"/>	Number	0	≥5	≥10	≥25	≥35	≥35	Annually		
Percentage of subprojects planned with adequate citizen engagement	<input type="checkbox"/>	Percentage	0	70 percent	85 percent	100 percent	100 percent	100 percent	Annually	Subproject activity reports from subnational governments.	Participating subnational governments will collect and report data to PT. SMI, which will in turn compile data to derive aggregate indicator values for RIDF as a whole.

Indicator Descriptions

Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Number of subnational governments receiving RIDF loans	Number of subnational governments	Annually	RIDF Annual Report	PT. SMI
Average loan size approved by RIDF	in IDR billions; target values are minimum values	Annually	RIDF Annual Report	PT. SMI
Average tenor of loans approved by RIDF	Loan tenor in years	Annually	RIDF Annual Report	PT. SMI
Return on RIDF assets	After-tax profits / average assets (percent); target values are minimum values	Annually	RIDF Annual Report	PT. SMI
Non-performing loans (NPLs)	Outstanding principal of past due loans/ Outstanding principal of all loans (percent); target values are maximum values	Annually	RIDF Annual Report	PT. SMI
Proportion of the total loan portfolio concentrated in a single sector	Value of RIDF loans in the largest sector / Total value of all RIDF loans (percent); target values are maximum values	Annually	RIDF Annual Report	PT.SMI

Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Amount of capital raised	US\$ Million based on loan commitments to subnational governments	Annually	RIDF Annual Report	PT.SMI
Number of subproject loans appraised	Number of proposals; target values are minimum values	Annually	RIDF Annual Report	PT.SMI
Percentage of subproject specific complaints received that are addressed/followed up by subnational governments	Number of subproject complaints addressed or followed-up/Number of subproject complaints received (percent); target values are minimum values	Annually	Subproject activity reports from subnational governments	Subnational governments and PT. SMI
Number of subnational governments applying for RIDF Project Development Facility services	Number of subnational governments; target values are minimum values	Annual	RIDF Annual Report	PT.SMI
Number of projects prepared with assistance from the RIDF Project Development Facility	Number of projects; target values are minimum values	Annually	RIDF Annual Report	PT.SMI
Percentage of subprojects planned with adequate citizen engagement	Number of subprojects planned with stakeholder consultations (e.g. musrenbang, safeguards public consultations, etc)/ Total number of subprojects (percent); target values are minimum values	Annually	Subproject activity reports from subnational governments	Subnational governments and PT. SMI

Annex 2: Detailed Project Description

1. This Project aims to support the Regional Infrastructure Development Fund (RIDF) as a retail domestic financial intermediary located within PT. SMI, in order to increase access to finance for basic environmental, productive and social infrastructure. RIDF will focus on financing economically-viable infrastructure that requires medium to long-term debt. It will be accessible to creditworthy subnational governments across Indonesia, at the provincial and district (*kota* and *kabupaten*) levels. RIDF is expected to target fast-growing medium and large *kota* governments across all island groups. RIDF will be structured around principles of financial sustainability, with a view to leverage market-based sources of finance in the medium-term.
2. The Government of Indonesia (GoI) has indicated its preference for a phased approach for RIDF, to enable refinement of RIDF's business model after the initial years of operation. Under the first phase, the World Bank and AIIB would each provide financing of US\$ 100 million, for a combined total of US\$ 200 million for half of the initial capital of RIDF. Subsequently, it is anticipated that additional financing of US\$ 300 million would be sought for a second phase, so that the aggregate total borrowing for RIDF would be US\$ 500 million.
3. This Project will also include the establishment of a Project Development Facility (PDF) for RIDF, to support the development of a subproject pipeline as well as to channel technical assistance to subnational governments in the areas of project identification, design and construction supervision, and related advisory services.
4. This Project will have two components: (i) Capital Support for RIDF; and (ii) RIDF Project Development Facility.

Component 1: Capital Support for RIDF (US\$ 400 million; comprising US\$ 100 million of IBRD financing, US\$ 100 million of AIIB co-financing, and US\$ 200 million of Borrower equity contribution)

5. This component will provide loans to participating subnational governments in Indonesia for selected infrastructure subprojects. Up to US\$ 400 million will be available for PT. SMI to use for RIDF, providing senior debt to subnational governments in Indonesia for economically viable infrastructure projects. Key RIDF design characteristics are described below.
6. **Capital Structure and Sources of Finance.** The proposed initial fund size of US\$ 400 million for the first four years would be sourced as a combination of equity from MoF/PT. SMI, and long-term debt from the World Bank and AIIB. A debt-to-equity ratio of 1:1 will be adopted to begin with. Based on the performance of the RIDF, subsequent capital infusions may be at a higher debt to equity ratio.
7. The Project will provide funding to PT. SMI to capitalize RIDF through a mix of debt and equity. The debt component will be provided as World Bank and AIIB financing channeled through a two-stage loan process: GoI (represented by MoF) will borrow from the World Bank and AIIB in foreign currency and on-lend the proceeds to PT. SMI in IDR. Under this arrangement, MoF will assume the exchange rate risk. The subsidiary loans from MoF to PT.

SMI will be priced to cover the exchange rate risk as per GoI regulations for lending to SOEs. MoF will apply GoI's standard interest rate for such subsidiary loans – applicable to all state-owned enterprises – which is the equivalent of the prevailing coupon rate of the 20-year SUN (Indonesian government bond), currently set at 8.25 percent¹⁵.

8. Matching equity contributions from GoI will be funded from cash that is currently available on PT. SMI's balance sheet. The source of this equity contribution includes asset transfers from the former *Pusat Investasi Pemerintah* (PIP), whose mandate for lending to subnational governments is now subsumed within PT. SMI. Additional equity contributions would come in the form of new capital injections from GoI, as needed.

9. **Pricing Policy and Cost of Funds.** RIDF will adopt a 'cost plus' pricing policy. The interest rate for RIDF loans to subnational governments will be based on the yield of the SUN corresponding to the tenor of the subproject loan in question, plus a margin of 75 basis points. As the lowest benchmark SUN rate is that of the 20-year SUN, currently 8.25 percent, this would imply an RIDF lending rate of at least 9 percent. This would be attractive for subnational governments: available funding for subnational governments in Indonesia has ranged from 9.5 percent under the previous PIP, to up to 11 percent under other commercial/institutional funds (though these have a very limited interest in lending to subnational governments). Moreover, commercial loans are short term (1 to 5 years) and only available for commercially attractive projects.

10. **Eligible Borrowers and Sectors.** RIDF will focus on lending to creditworthy district-level and provincial governments. It is expected that RIDF's initial five-year business plan will focus on district-level (*kota* and *kabupaten*) governments under a general obligation borrowing framework, before scaling up to more complex regional projects at the provincial level as RIDF's appraisal and financial capacity deepens. In the medium term, RIDF could also lend directly to locally-owned enterprises (e.g. PDAMs) and Perusahaan Daerah (PD); debt obligations for such loans could rest with subnational governments, who could also transfer assets and potentially liabilities to such enterprises.

11. RIDF will focus on an open menu of viable environmental, social and productive infrastructure that fall within the clear jurisdictional responsibility of district-level and provincial governments under the Indonesia's decentralized framework. Eligible sectors include: water, sanitation, sewerage, drainage, solid waste, urban transport including roads, slum upgrading, and primary healthcare and education facilities. Table A2.1 below provides details of eligible sectors and subprojects that are within the framework of RIDF financing.

12. **Security mechanism.** Law 33/2014 on Fiscal Balance stipulates that if a subnational government fails to make a loan repayment, then this obligation can be accounted for against the DAU or DBH transfers that the subnational government is otherwise entitled to. The detailed procedures for such intercepts are described in the Government Regulation PP No. 30/2011

¹⁵ MoF has the ability to charge PT. SMI a lower rate for this project, as provided for in Ministerial Regulation No. 40/PMK.05/2015, since municipal lending is classified as a special assignment ("*penugasan*") to PT. SMI from MoF.

(Article 64), and the Ministerial Regulation PMK 47/07/2011. Therefore, a security structure has been designed for RIDF that is a post-default guarantee with intercept mechanism (see Figure A2.1 below), that would provide protection to PT. SMI in the case of RIDF borrower default. Under this structure, all RIDF lending would be covered by a full guarantee from MoF in the case of default by a subnational government. A contingency fund will be set up at MoF for this purpose. Upon the triggering of the guarantee, MoF would transfer the necessary amount from the contingency fund to PT. SMI to cover the value of the executed guarantee. MoF would then intercept intergovernmental transfers to the subnational government in question, to replenish the contingency fund.

Table A2.1: Eligible Sectors and Subprojects

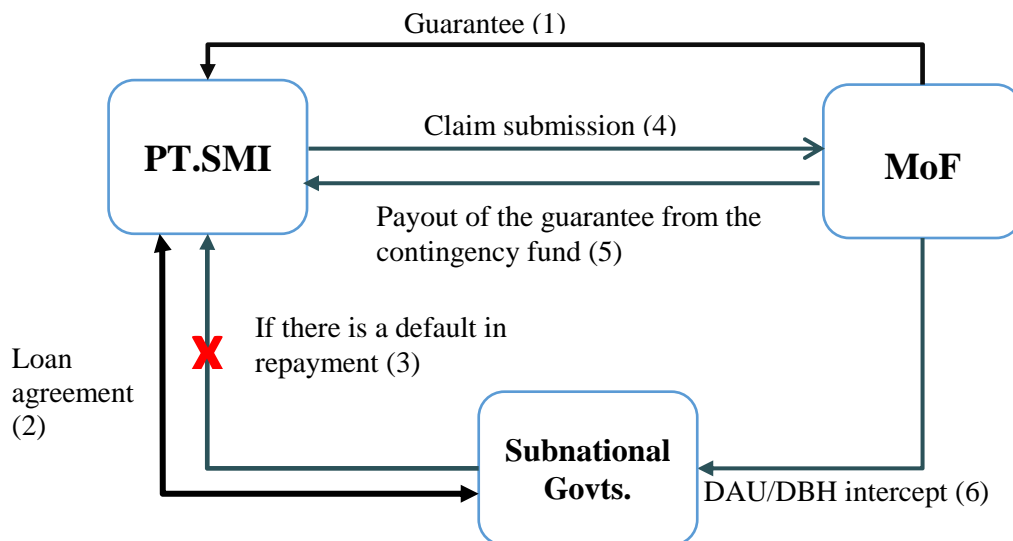
Eligible Sectors		Eligible Subprojects
1	Water Supply and Sanitation	<p><u>Water Supply</u></p> <ul style="list-style-type: none"> • Construction/rehabilitation/capacity augmentation of dams, lakes and reservoirs for the purpose of supplying water to urban areas. Eligible costs shall include expenses towards embankments, earthen works, diversion channels, source diversion and other similar works. • Construction of infrastructure incidental to source augmentation such as construction of jack-wells/bore wells, pumping equipment, etc. • Development of new water treatment plants and capacity augmentation of existing treatment plants including treatment technologies, civil works, etc. • Construction and laying of raw water transmission and treated water distribution systems (pipes, pumping stations, tanks, etc.). Includes replacement and/or rehabilitation of existing water supply systems. • Installation of water meters at consumer and bulk connections and associated monitoring systems. • Implementation of SCADA and other systems for monitoring and pressure control. • Construction and installation of desalination plants for urban water supply in coastal areas. <p><u>Sewerage</u></p> <ul style="list-style-type: none"> • Collection network and treatment facility for wastewater. • Pumping stations and machinery. • Regional facilities and system automation.
2	Environmental Infrastructure	<p><u>Solid Waste Management</u></p> <ul style="list-style-type: none"> • Construction of municipal solid waste processing facilities (sanitary landfill, waste processing plant, incineration unit, etc.). • Construction of processing facility for construction and demolition waste. • Waste recycling projects. • Purchase of vehicles and bins for solid waste collection.

Eligible Sectors		Eligible Subprojects
		<ul style="list-style-type: none"> • Development of vehicle-tracking and waste disposal monitoring systems. <u>Drainage</u> <ul style="list-style-type: none"> • Development of storm water drainage networks. • Rehabilitation of existing drainage networks. • De-silting and/or strengthening of natural drains. <u>Energy Efficiency</u> <ul style="list-style-type: none"> • Improvement of electric installations and equipment in buildings and public facilities. • Retrofitting buildings and infrastructure for greater energy efficiency. • Improving systems that control energy consumption.
3	Low-Income Housing and Slum Upgrading	<ul style="list-style-type: none"> • Public housing units in slum areas (in-situ upgrading and/or relocation). • Integrated urban upgrading including water, sewerage, drainage, roads and street lighting, etc.
4	Transportation and Logistics Infrastructure	<ul style="list-style-type: none"> • New carriageway development (at-grade, flyovers, bridges). • Road rehabilitation, upgrading and/or widening. • Junction-improvement projects • Development of mass transit (non-rail-based) infrastructure. • Development of pedestrian infrastructure (pedestrian bridges, footpaths, street furniture, street lighting, etc.). • Purchase of public buses. • Development of street furniture for bus stops. • Development of bus depot and shelters. • Development of dedicated BRT lane and related infrastructure, tracking and monitoring system for operating BRT etc. • Development of multi-level car parking structures. • Development of traffic monitoring and management systems. • Development of building and/or facilities to house traffic management units. • Development of irrigation infrastructure.
5	Social Infrastructure	<ul style="list-style-type: none"> • Development of new hospitals, schools and public markets. • Rehabilitation and/or expansion of hospitals, schools and public market facilities. • Development of facilities incidental to social infrastructure, such as parking facilities and equipment (medical equipment and beds for hospitals, teaching aids and furniture for schools, storage and warehousing for markets, etc.)

13. To facilitate this security mechanism for RIDF, MoF is issuing three ministerial regulations (PMKs). The first regulation stipulates a special assignment and guarantee to PT.SMI in relation to its municipal lending business. This regulation addresses the guarantee scheme, eligibility criteria for borrowing from RIDF, types of infrastructure funded, pricing policy, risk

mitigation and monitoring, etc. The second regulation relates to the procedures for intercepts of the DAU (general purpose grant) and DBH (revenue sharing grant) transfers to subnational governments¹⁶. The third regulation specifies the internal procedures for creating and managing the contingency fund at MoF.

Figure A2.1: Proposed Security Mechanism for RIDF



14. RIDF will also rely on a combination of prudential lending norms and rigorous appraisals to considerably reduce the probability of defaults, and in turn the need to fall back on the security mechanism. A rigorous appraisal process would first and foremost ensure that only financially robust subnational governments, who also have the technical capabilities to design and implement a subproject, would be able to obtain RIDF loans. In addition, the appraisal process would identify key repayment risks at every stage of the Project; for example: regulatory risks prior to commencement, construction risks, operations and maintenance risks etc. These risks would be mitigated by appropriate loan covenants and pre-disbursement conditions, which would be stipulated in the individual loan agreements with subnational governments.

15. A prudential lending policy with exposure norms defined with respect to borrowers, sectors and projects is expected to ensure that RIDF's portfolio is well diversified and not exposed to undue risks. The proposed prudential norms are as follows:

- Maximum loan value of 90 percent of the total cost of a subproject¹⁷;
- Single borrower limit of not more than 15 percent of RIDF's total assets;
- Single subproject limit of not more than 10 percent of RIDF's total assets;
- Single sector limit of not more than 35 percent of RIDF's total assets.

¹⁶ This second regulation constitutes a revision of PMK No. 47/07/2011 on intercepts of intergovernmental transfers in the case of subnational default.

¹⁷ The total cost of a subproject comprises not only construction costs, but also other costs such as subproject preparation, design, supervision, goods, and land (if applicable). Therefore, a subproject loan could finance 100 percent of construction costs, within the overall limit of the total subproject cost.

Component 2: RIDF Project Development Facility (US\$ 6 million; comprising US\$ 3 million of grant financing from the IDSUN MDTF, and US\$ 3 million of Borrower contribution)

16. This component will provide support for subnational governments in carrying out subproject identification and preparation, including, but not limited to, feasibility studies, detailed engineering designs, environmental and social safeguard assessments, advisory services on financial management and procurement, and training. The RIDF Project Development Facility (PDF) will support subnational governments in the process of preliminary feasibility assessment, detailed engineering design and subproject preparation. The PDF will provide financing for the preparation of subprojects that are potentially eligible for RIDF funding. The PDF will help to lower the costs of project preparation for subnational governments, provide expert assistance in standardizing designs, and produce a pipeline of potential subprojects that are eligible for financing under RIDF.

17. **Eligible entities/sectors:** The PDF will assist subnational governments that would be eligible borrowers under RIDF, for subprojects that would be eligible for RIDF funding. To be eligible for assistance from the PDF, subnational governments will also need to fulfil the following criteria:

- The proposed subproject must be listed in the budget and capital investment plan of the subnational government;
- The subnational-level legislature (DPRD) should have committed to undertaking the subproject, provided it is technically feasible and economically sound;
- A core project team with appropriate delegation of authority is established to work with the PDF.

18. **Scope of assistance:** The PDF's support to subnational governments would be limited to the activities listed below; all other activities would have to be undertaken by subnational governments through their own internal resources/other sources of funding.

- i) project identification and preliminary structuring;
- ii) project preparation studies, including feasibility studies, detailed engineering designs and environmental and social safeguards instruments;
- iii) design and supervision assistance;
- iv) advisory services related to financial management, environmental and social assessments, etc.;
- v) preparation of procurement and contract documents; and
- vi) training for subnational governments on the above.

19. **Accessing PDF assistance.** To access assistance from the PDF, a subnational government would make an application to PT. SMI using the designated template. The application would provide basic information on the subnational government's technical and financial capabilities, the broad contours of envisaged subproject including the need and justification for it, and other details. A team from the PDF would conduct a preliminary visit to the subnational government and proposed subproject location. This screening would assess the preliminary technical and financial viability of the subproject within the scope of RIDF's lending

criteria. Based on this visit, the PDF application would be assessed and a decision made on the suitability of the proposal for PDF support.

20. Once an application has been approved, the PDF and subnational government would enter into an agreement that would clearly set out the areas of support to be provided by the PDF, and the roles and obligations of the subnational government. This agreement would also clarify that PDF support would not in any way guarantee funding from RIDF, and that the subnational government would be free to take the project to any other funder that it may deem fit. (By the same token, accessing PDF support is not necessary in order for a subnational government to qualify for financing from RIDF. Subnational governments can prepare the projects themselves and submit these directly to RIDF.) The agreement would also highlight the independence of the PDF from RIDF itself. The resulting feasibility studies, detailed engineering designs studies and environmental and social safeguards documents financed by the PDF would be the property of the respective subnational governments.

21. **PDF independence.** To avoid potential conflicts of interest, the PDF will be housed under a separate business unit within PT. SMI, specifically under the Project Development and Advisory Directorate. This directorate already undertakes activities similar to those proposed for the PDF, which would become an additional activity under the same directorial oversight. The PDF will be managed by a team of specialists in the area of urban infrastructure and subnational government financing, and would naturally adopt the same eligibility and compliance standards of RIDF.

22. **Financial sustainability.** Given the importance of the activities to be supported by the PDF, it would be important for the PDF to have an ongoing and sustainable source of financing. Options for ensuring the financial sustainability of the PDF include a small spread on all RIDF loans with proceeds earmarked for the replenishment of the PDF. Alternatively, a portion of PT. SMI's dividends could be set aside for funding the PDF.

23. **Startup phase.** The focus of the PDF in this initial phase will be to proactively approach subnational governments and build the initial pipeline for support on subproject development. To start with, the PDF will identify 8 to 10 potential subprojects, and begin to provide the necessary support to each subnational government.

24. The design of the PDF described here is consistent with good practice cases of similar facilities in countries like India, the Philippines and South Africa. Most of these facilities are revolving funds financed by the respective government and international agencies. They provide assistance in the areas of undertaking pre-feasibility studies, environmental and social impact assessments, project documentation and preparation of detailed project reports. Six similar facilities reviewed were: i) Southern Africa Development Community (SADC) - Project Preparation and Development Facility (PPDF); ii) Municipal Development Fund Office (MDFO) - Local Government Finance and Development (LOGOFIND) Project, Philippines; iii) Project Preparatory Grant Fund (PPGF) under the Tamil Nadu Urban Development Fund (TNUDF), India; iv) Project Development Facility (PDF), Government of South Africa; v) Project Development and Monitoring Facility (PDMF), Philippines; and vi) India Infrastructure Project Development Fund (IIPDF), Government of India.

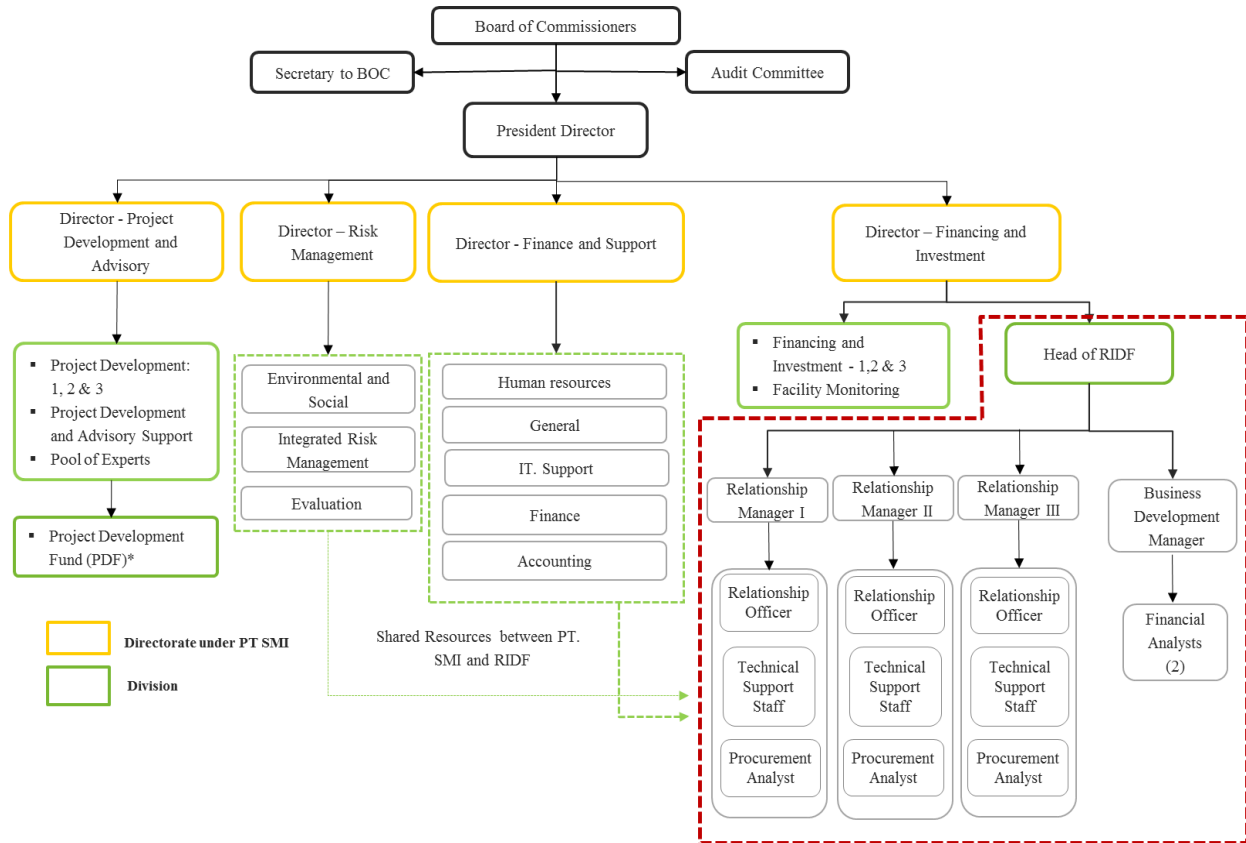
Annex 3: Implementation Arrangements

Institutional Arrangements

1. PT. SMI will be the implementing agency for RIDF. The decision to locate RIDF within PT. SMI allows RIDF to be organized with three core design features. First, although it is a state-owned enterprise, PT. SMI has an independent and autonomous management and operational structure that enables it to develop and maintain rigorous appraisal criteria and to make independent credit decisions. Second, PT. SMI has a limited liability structure, and is subject to the discipline of borrowing and repaying debts from its own discrete balance sheet. Third, as part of PT. SMI, RIDF will be able to build its capital base over time and mobilize additional funds including from the private capital markets.
2. RIDF will be managed within PT. SMI under the Directorate Financing and Investment, with its own staffing, KPIs, policies and procedures. This would increase the accountability of RIDF, resulting in an enhanced focus on its operations and significantly better visibility of its operational and financial performance. RIDF would begin with a lean organizational structure, with a full-time unit head, regional/relationship managers, and specialists on engineering procurement. Other functions such as internal audit, finance and accounting, legal, environmental and social safeguards, IT, HR and others would be shared with other divisions of PT. SMI.
3. RIDF will be managed according to the existing decision-making systems and governance structure of PT. SMI. The Board of Commissioners of PT. SMI would provide overall strategic oversight. The Board of Directors (BoD) would take decisions on operations and investments. An operations committee internal to RIDF would undertake first level reviews of proposed subprojects, before these are presented to the Board of Directors for their approval. Figure A3.1 below illustrates the organizational structure of RIDF, within the overall structure of PT. SMI.
4. The Directorate General of Budget Financing and Risk Management of MoF will have the primary responsibility for managing the World Bank and AIIB loans for RIDF, as well as for overseeing the security mechanism for RIDF. The Directorate General of Treasury will be responsible for the subsidiary loan agreements (SLAs) between MoF and PT. SMI, and for processing and transferring loan funds to PT. SMI. Drawdowns from the World Bank and AIIB loans will be made on the basis of requests from PT. SMI to MoF, and thence from MoF to the World Bank (for further details, see the section on Financial Management below).
5. As per current GoI regulations, RIDF will function within a regulatory environment that includes several GoI institutions. The role of each institution is as follows:
 - i. MoF: Relevant regulations on subnational borrowing, fiscal and debt management;
 - ii. OJK: Guidelines for operation as a non-bank financial institution, particularly to meet the micro-prudential requirements issued by OJK;
 - iii. MoHA: Regulations pertaining to investments and borrowing by subnational governments;
 - iv. BPK: Financial reporting on GoI's assets and the portfolio of subnational government loans under RIDF; and

- v. Line ministries/agencies: Technical guidelines as applicable for each RIDF subproject.

Figure A3.1: Organization Structure for RIDF within PT. SMI¹⁸



Project Operations Manual

6. An Operations Manual (OM) for RIDF has been developed by PT. SMI and MoF. The OM provides detailed operating policies and procedures that will be used for RIDF to process, appraise, provide, and monitor loans to subnational governments; undertake procurement for meeting its own requirements and for also overseeing compliance and monitoring performance of the procurement undertaken by the subnational governments; implement environmental and social safeguards; and for general financial management (planning, budgeting, accounting and financial reporting). The OM also includes the operating policies and procedures of the PDF.

Financial Management (FM)

7. A Financial Management Assessment (FMA) has been conducted as part of the Fiduciary Assessment of the Project. The FMA assesses the adequacy of the financial management system

¹⁸ The proposed organization structure of RIDF reflects the latest organizational structure of PT.SMI

of the implementing agency, PT. SMI, to produce timely, relevant and reliable financial information on Project activities. The FMA also assesses if the accounting systems for Project expenditures and underlying internal controls are adequate to meet fiduciary objectives, and allow the World Bank to monitor compliance with agreed implementation procedures and appraise progress towards these objectives.

8. **Institutional Arrangements.** The Project will be implemented by PT. SMI. A PMU will be established within PT. SMI. Satker of Directorate SMI within MoF will be responsible for all funds transfers made to PT. SMI.

9. Project implementation will follow PT. SMI's operational guidelines, while specific Project implementation guidelines are covered in the RIDF Operations Manual (OM) that includes the following:

- Organization structure;
- Inclusion of the Project budget into the DIPA of MoF;
- Preparation of payment and supervision schedules for each subproject;
- Simple guidelines for subnational governments on how to manage the funds, including inclusion of subproject budgets into DIPA, reporting mechanism, etc.;
- Funds flow mechanism;
- IFR preparation and submission to the World Bank;
- Disbursement mechanism when payments are due to subnational governments;
- Withdrawal application process;
- Internal and external audit arrangements;
- Periodic reminders on installments for subnational governments;
- Coordination among all stakeholders of the Project.

10. **Budgeting.** In Indonesia, financing arrangements for World Bank projects implemented by GoI agencies are governed by an integrated budget or DIPA. The sources of financing for project activities, including financing percentages, are detailed in DIPA and strictly followed.

11. The budget for Component 1 of the Project will be included in the DIPA of DG Treasury of MoF, for on-lending to PT. SMI. Under this Project component, the loans from the World Bank and AIIB will co-finance subproject expenditures in equal shares. These expenditures will be financed from the World Bank and AIIB loan proceeds at 100 percent of their respective shares. Counterpart funds of US\$ 203 million will finance subprojects under Component 1 identified to be covered by the government's own funds, as well as operating costs under Component 2. PT. SMI is expected to work closely with the planning bureau and Directorate SMI in MoF to ensure timely issuance of the DIPA that includes the proposed disbursement plan for both the World Bank and AIIB funds.

12. PT. SMI will also ensure that subproject budgets are included in the respective APBD of each subnational government, through the subproject financing agreements. Payments from subnational governments to third parties can only be made if the subproject budgets are included in the APBD.

13. For the RETF under Component 2 of the Project, the grant agreement will provide funds directly to PT. SMI, and no allocation in the DIPA is necessary.
14. The budgeting process is described in greater detail in the RIDF OM.
15. **Subproject Financing Agreements.** Each subproject financing agreement between PT. SMI and participating subnational governments will include the following requirements:
- All proposed drawdowns for subprojects included in APBD of the respective subnational government.
 - All subloan repayments, installments and interest, for subprojects included in APBD of the participating subnational governments.
 - Audit reports of participating subnational governments are to be submitted to PT. SMI.
 - Subproject draft contracts are subject to review by PT. SMI.
16. **Payment Verification.** Supervision consultants will issue Monthly Certificates (MCs) for all subprojects. MCs will be compiled and used as needed for payment processing by the Relationship Manager (RM) for each subproject. The RM will ensure that all supporting documentation (including evidence of funds transfers made to contractors from previous payments) is in order. The RM will then forward the information to technical experts for verification of progress, before requesting the release of payments by the finance unit of PT. SMI. In general, the RM will be responsible to monitor the progress of subproject implementation by subnational governments. For the RETF, payment verification will follow PT. SMI's internal procedures which are acceptable to the World Bank.
17. **Accounting and Reporting.** PT SMI uses Oracle for their accounting system, which records and stores all journal entries and produces monthly financial reports, monthly cash flow statements and bank reconciliation reports. RIDF Project expenditures will be integrated in this accounting system, which can generate transaction information based on sources of funds. The Finance unit of PT. SMI will be responsible for submission of the Project's Interim Financial Report (IFRs) to the World Bank. IFRs using the agreed format will be submitted to the Bank through MoF on a quarterly basis, within 45 days of the end of each reporting period.
18. **Internal Audit Arrangements.** PT. SMI has its own internal audit unit, which will ensure (through compliance audits) that the respective subnational government inspectorates will perform internal audits of subprojects. Reports from these inspectorates and from PT. SMI related to subprojects will be shared with the World Bank. PT. SMI's internal audit unit will also do internal audits of the RETF implementation. The OM includes further details of the internal audit arrangements for the Project.
19. **External Audit Arrangements.** The Loan will be subject to external audit. Each audit will cover a period of one fiscal year of the recipient. The World Bank will accept PT. SMI's corporate audit with disclosure on the use of the Bank's funds, as reflected in audit Terms of Reference acceptable to the Bank. Audit reports and audited financial statements will be furnished to the Bank no later than six months after the end of the fiscal year concerned and will be made available to the public.

20. **Flow of Funds.** Under the World Bank and AIIB loans, there will be subsidiary loan agreements between MoF and PT. SMI. The agreed annual budget for the Project will be allocated in the DIPA/APBN of the Directorate SMI within DG Treasury of MoF. Two separate Designated Accounts (DAs) will be opened – one DA for the World Bank and AIIB loans, and another DA for the RETF.
21. In turn, PT. SMI will enter into financing agreements with participating subnational governments to finance subprojects. For each subproject, PT. SMI will make payments to the general bank account of the subnational government (*rekening kas umum daerah*), based on invoices from the subproject contractors verified by the RM, and supported with MCs approved by the supervision consultants. The subnational government would then make the appropriate payments to the contractors.
22. Under the Advance method, the flow of funds is as follows:
- i. A Designated Account (DA) will be opened at PT. SMI.
 - ii. PT. SMI submits a request for an advance to the Bank through Directorate SMI of MoF (drawing from both loans equally). In the case of the RETF, PT. SMI will submit requests directly to the World Bank.
 - iii. Directorate SMI then forwards PT. SMI's request to the World Bank.
 - iv. The World Bank forwards the request to AIIB.
 - v. The World Bank and AIIB will each transfer their respective shares for the initial deposit (advance) to the DA based on the request (using the IFR format which includes a projection of Project needs for the next six-month period).
 - vi. PT. SMI transfers the funds from the DA (of the World Bank and AIIB) to participating subnational governments. No transfers to subnational governments will be made for the RETF.
 - vii. Additional transfers can be made based on request (using the IFR format which includes a projection of Project needs for the next six-month period).
23. Alternatively, PT. SMI may opt for the pre-financing method where instead of transferring funds to the DA, the World Bank and AIIB transfer funds to PT. SMI's account as reimbursement for the pre-financing amount.
24. These arrangements for flow of funds are described in further detail in the OM.
25. **Disbursement Arrangements.** The applicable disbursement methods are Advance and Reimbursement. For the loans from the World Bank and AIIB, a DA under the name of PT. SMI and denominated in IDR will be opened at a government-owned or commercial bank acceptable to the World Bank. Advances from the World Bank and AIIB will be deposited in this DA and will be used solely to finance eligible expenditures under Component 1 of the Project. For the RETF, a DA under the name of PT. SMI and denominated in US\$ will also be opened at a government-owned or commercial bank acceptable to the World Bank. This DA will be used for financing eligible expenditures under Component 2 of the Project. Both DAs will be segregated accounts with fluctuated ceiling. Disbursement arrangements for the Project are reflected in the OM and have been agreed with the World Bank. Applications for the replenishment of the DA

advance maybe submitted through quarterly IFRs which consist of: (i) DA Activity Statement; (ii) Statement of Expenditures under Bank’s prior review and non-prior review; (iii) Project Cash Forecast for the next six-month period; and (iv) Project Sources and Uses of Funds.

26. The disbursement categories and funds allocations for activities financed by the World Bank and AIIB loans, and by the RETF grant, are outlined in the table below.

Table A3.1: Allocation of Loan and Grant Proceeds

Category	Amount of the World Bank Loan Allocated (US\$)	Amount of the AIIB Loan Allocated (US\$)	Amount of the RETF Grant Allocated (US\$)	Percentage of Expenditures to be Financed
Works and goods under Component 1 of the Project	100,000,000	100,000,000	-	100 percent
Goods, consultants’ services, and training under Component 2 of the Project	-	-	3,000,000	100 percent
TOTAL	100,000,000	100,000,000	3,000,000	

27. **Retroactive Financing under Component 2.** PT. SMI has requested that retroactive financing be permitted for the RETF grant-funded activities under Component 2 of the Project. Accordingly, this retroactive financing will be consistent with the guidelines as stipulated in the World Bank’s Trust Fund Handbook, including: (i) the Grant Agreement includes a provision for retroactive financing; (ii) payments are for items procured according to the applicable procurement procedures (as described in this PAD and in the Project’s procurement plan); (iii) the maximum amount of retroactive financing is 20 percent of the grant amount, i.e. US\$ 600,000; (iv) payments are incurred on or after November 1, 2016, which is within 12 months of the expected signing date of the Grant Agreement and after the signing date of the IDSUN Administration Agreement.

28. **Supervision Plan.** Risk-based supervision of Project financial management will be conducted. This will involve desk supervision, including review of IFRs and audit reports, as well as field visits. Financial management supervision will be conducted every six months together with the rest of the World Bank’s task team, as part of Project implementation support.

Procurement

29. Procurement under the Project will be carried out in accordance with the World Bank’s “Guidelines: Procurement of Goods, Works and Non-Consulting services under IBRD Loans and IDA Credits and Grants by World Bank Borrowers” dated January 2011, revised July 2014 and “Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers” dated January 2011, revised July 2014; including paragraph 3.13 “Procurement in Loans to Financial Intermediary Institutions and Entities”, and the provisions stipulated in the Financing Agreement.

30. Under Component 1 of the Project, which constitutes the bulk of the procurement by value and number under the Project, it is expected that the subnational governments as beneficiaries of the sub-loans will use the proceeds for their subprojects mainly for procurement of works, and in some limited cases for goods, but not for non-consulting or consulting services. Most of the works and goods contracts are expected to fall under the National Competitive Bidding (NCB) method, in which the Government's Procurement Regulations (Perpres No.10/2015 and its amendments) may be used subject to certain improvements required for consistency with the World Bank's Procurement Guidelines. Such improvements are listed in the NCB Annex to the Loan Agreement and also incorporated in the harmonized NCB model bidding documents for procurement of works through the national e-procurement system, SPSE. This NCB model bidding document, which was issued by the Head of the National Procurement Policy Agency (LKPP) through Perka No.21/2015 dated in September 30, 2015, shall be used for NCB procurement of works under the Project using the SPSE e-procurement system. For procurement of goods, the harmonized NCB model bidding documents acceptable to the Bank shall also be used. It is envisaged that there may also be some contracts for works requiring use of the International Competitive Bidding (ICB) method, which shall be procured using the Bank's ICB Standard Bidding Documents. For ICB, the bidding process shall be carried out manually and the SPSE e-procurement system shall not be used, until such time that the SPSE system has been determined by the Bank to be non-restrictive, consistent with the Bank's procurement procedures, and confirmed in writing as being acceptable for use in the procurement of goods and works under the ICB method. As the works are expected to be of non-complex nature, post-qualification procedure shall be used regardless of contract value, and prequalification procedure will not be applicable.

31. For each subproject, PT. SMI will assess the capacity of subnational governments to carry out procurement effectively; approve acceptable procurement plans for each subnational government; undertake supervision and oversight to ensure that all procurement processes carried out by subnational governments are in compliance with agreed procedures; monitor overall procurement performance; and maintain all relevant records. PT. SMI will also provide support to the subnational governments in the form of workshops, training and/or technical assistance as needed to strengthen their capacity for carrying out procurement and contract management under the sub-loans. The procurement arrangements, including the applicable methods of procurement consistent with the Financing Agreement, the roles and responsibilities of PT. SMI and of the subnational government beneficiaries of the sub-loans in the management and oversight of procurement and contract implementation, including ensuring compliance with the Bank's Procurement and Anti-Corruption Guidelines, establishing a complaints handling mechanism, checking for indicators and taking corrective action in case of integrity related issues, and screening out Bank-sanctioned firms from being awarded contracts, are detailed in the Operations Manual (OM) prepared by PT. SMI and approved by the World Bank.

32. Under Component 2, the Project Development Facility (PDF) will be established under PT. SMI and consulting services will be procured by PT. SMI to strengthen its own capacity and also support subnational governments in the areas of subproject identification, design, and related advisory services. This includes procurement capacity building and strengthening procurement oversight to mitigate the risk due to PT. SMI and the subnational governments' lack of knowledge and experience of the Bank's procurement procedures and also the generally weak

governance environment in the country. In the selection of consulting firms, the World Bank's standard Request for Proposal documents shall be used and the selection process shall be carried out manually and not using the SPSE e-procurement system, until such time that the SPSE system has been determined by the Bank to be non-restrictive, consistent with the Bank's selection procedures, and confirmed in writing as being acceptable for use in the selection of consultants. Selection of individual consultants shall be carried out through competitive selection by comparing at least three candidates. PT. SMI will assign dedicated and qualified persons who will oversee compliance and monitor performance of the procurement carried out by subnational governments under Component 1, and also to carry out PT. SMI's own procurement under Component 2. The Bank will assist PT. SMI in preparing the procurement plan for Component 2 and also deliver training on the Bank's Procurement procedures. In addition to carrying out procurement supervision, including prior and ex-post reviews of PT. SMI's own procurement in accordance with the approved procurement plan, the Bank will also regularly monitor the adequacy of PT. SMI's supervision and oversight of the procurement processes carried out by the subnational governments, including verifying the quality of prior and post reviews carried out by PT. SMI and the procurement audits done by the national auditors.

Environmental and Social (including safeguards)

33. As an FI Project, the environmental and social impacts of subprojects will have to be managed by the subnational governments receiving financing from RIDF and the PDF. Based on the Market Assessment Study and the applications from subnational governments to PT.SMI (see Annex 6), the size of potential subprojects ranges between US\$ 10 and 90 million, with the potential for medium to high environmental and social impacts. Involuntary resettlement, including land acquisition, may take place for newly developed subprojects. On-site redevelopment or expansion of infrastructure may not need to acquire land, but social issues arising from temporary relocation of traders, for instance, will have to be managed properly. As subnational governments seeking support from RIDF are geographically located across Indonesia, some subprojects may also affect indigenous peoples. At this point, however, the specific environmental and social impacts of subprojects cannot be defined as their exact footprints and impact areas are not yet known.

34. PT. SMI has prepared a single Environmental and Social Management Framework (ESMF) for RIDF (Component 1) and the PDF (Component 2). The ESMF includes a Land Acquisition and Resettlement Policy Framework (LARPF), Process Framework (PF), and an Indigenous Peoples Planning Framework (IPPF), as well as Grievance Redress Mechanisms and Disclosures. The draft ESMF was disclosed on PT. SMI's website on June 15, 2016, and submitted for disclosure through the World Bank's Infoshop on July 18, 2016. Consultations with stakeholders on the draft ESMF were held on June 21 and 22, 2016. The final version of the ESMF incorporating relevant inputs from the stakeholder consultations was disclosed on PT. SMI's website and the Infoshop on November 3, 2016. The ESMF will be included in the Operations Manual that will be used by RIDF and the PDF.

35. The ESMF has been developed on the basis of PT. SMI's current Environmental and Social Management System (ESMS) and Environmental and Social Standards (ESS). The current ESMS has adopted national laws and regulations pertaining to land acquisition and

environmental management, and applies to projects funded from PT. SMI's own financial resources. Recently, PT. SMI has also adopted 10 ESSs that reflect national laws and regulations as well as some international standards, which apply to projects financed by multilateral agencies. PT. SMI currently uses both the ESMS and ESS in its operations, mainly PPP projects, whereby social (and environmental) safeguards due diligence is undertaken once a subproject is defined as eligible for financing based on the financial and investment assessments. A Corrective Action Plan to meet ESMS requirements is prepared based on gaps identified in the due diligence assessment, and its implementation is covenanted in the loan agreement between PT. SMI and the borrower. In future, once RIDF is established, PT. SMI will use the ESMF for the operations of RIDF and the PDF, regardless of the financing sources that support the RIDF and PDF operations.

36. PT. SMI has established a special unit of RIDF under its Directorate of Financing and Investment to manage RIDF exclusively. Similarly, the PDF has been established under the Directorate of Project Development and Advisory. PT SMI has also established an Environmental and Social Safeguards and Business Continuity Management Unit (ESSBCM) under the Directorate of Risk Management. At present it has a senior environmental expert and a junior environmental specialist as well as a social safeguards specialist (to be mobilized in mid-August 2016). Specific in-house as well as outside trainings will be provided to the environmental and social safeguards experts. A pool of environmental and social safeguards experts will also assist the ESSBCM Unit, and as needed, PT SMI will also hire consulting firms to help this unit in screening, reviewing documents submitted by the subnational governments and supervising the implementation of the safeguards documents. In addition, the safeguards experts of the ESSBCM unit will provide training social and environmental safeguards management for subnational government staff.

37. Key safeguards risks related to lack of capacity in preparing and implementing safeguards instruments, among both subnational governments and PT. SMI, have been identified. The most effective way to mitigate this risk is by providing close and intensive support and mentoring on safeguards implementation to PT. SMI. At the same time, subnational governments will receive substantial support from PT. SMI through the PDF mechanism. Ongoing monitoring and implementation support will be provided to PT. SMI to help ensure that subnational governments fulfill the requirements specified in the ESMF. This will include advice on aspects including the subproject screening process, TORs for safeguards documents (ESIA, LARAP), the appraisal methodology, and also gap filling between Indonesia's country systems and the World Bank's safeguards policies.

38. For the first five high-risk subprojects, the World Bank will conduct joint appraisal and review together with PT. SMI prior to subproject approval. If found to be necessary during Project implementation, this joint prior review approach could be extended to additional high-risk subprojects beyond the first five. As part of regular Bank supervision of Project safeguards implementation, for medium and low-risk projects the Bank will monitor RIDF's operations through post-review to ensure that the ESMF is consistently adhered to, and promptly initiate any corrective action as required.

Monitoring and Evaluation

39. The Project's Results Framework provides the basis for measuring progress towards the Project's objectives. It includes the PDO-level outcome indicators related to increasing access to infrastructure finance at the subnational level, and the financial performance and sustainability of RIDF, as well as component-specific intermediate indicators, with baselines and targets for each over the life of the Project. Two types of monitoring and evaluation activities will be carried out during Project implementation: regular monitoring, and a Project mid-term review (MTR). An independent impact evaluation will be conducted at the completion of the Project to assess the achievement of the final Project results.

40. PT. SMI will be principally responsible for Project monitoring, including reporting on the outcome and intermediate indicators on a regular basis. This would include monitoring progress of the two Project components, financial management, procurement process, safeguards and progress on achievement of results indicators. PT. SMI will coordinate with GoI and subnational governments to conduct regular field visits to subprojects. RIDF will be closely monitored by MoF, with at least 4 directorates-general of MoF involved: DG State Assets, DG Fiscal Balance, DG Budget Financing Management and Risk Management, and DG Treasury. The specific roles of each DG are defined in the Operations Manual.

41. The World Bank will conduct, at a minimum, semi-annual implementation support missions together with PT. SMI and relevant ministries. If needed, these missions can be undertaken more frequently. These missions will review Project progress, performance, management issues, and provide technical assistance and feedback to improve the overall performance of the Project. Risk-based supervision of Project financial management will be conducted. This will involve desk reviews of IFRs and audit reports, and at least one mission in each year. Financial management supervision will be conducted by Bank consultants under Financial Management Specialist direction. The results of each supervision mission will be discussed with the responsible agencies for improvement of Project implementation and for designing technical assistance, as needed.

Annex 4: Implementation Support Plan

1. As part of RIDF implementation, GoI has requested the World Bank to provide implementation support during the initial years of RIDF and PDF operations. The objective of this support is to ensure that PT. SMI staff can run RIDF and the PDF smoothly and sustainably in the medium to long-term, with the ultimate aim of enabling participating subnational governments to plan and implement subprojects effectively. The activities described here will be funded through existing trust fund resources available at the Bank, including through the Indonesia Sustainable Urbanization Multi-donor Trust Fund (IDSUN MDTF), as well as the Indonesia Infrastructure Support Trust Fund (INIS TF).

2. Broad scope for Implementation Support for RIDF. The broad areas of support include subproject development, subproject appraisal, assistance to procurement, Project monitoring, safeguards management, and other hands-on support. Activities will include development and refinement of standard documentation guidelines, standard operating procedures, and templates for investment capacity assessment at the subnational level. Specific activities will include:

- a) Subproject Development and Outreach Activity Support
 - i. Assist the outreach team of RIDF and PDF in developing and implementing preliminary checklists to help identify suitable subprojects;
 - ii. Assist the PDF team in identifying the key issues that would be critical to the successful approval of each subproject and how to assess these prior to investing significant PDF funds;
 - iii. Assist in development of consultant TORs, including subproject feasibility studies and detailed engineering designs, as well as safeguards instruments;
 - iv. Advise and support the PDF team in reviewing all submissions by external consultants, including feasibility reports, DEDs, etc.;
 - v. Contribute to the preparation of guidance notes and training materials for the PDF. The guidance and training materials would be practical resources for subnational governments and RIDF staff, on topics such as environmental and social safeguards, citizen engagement, gender, and climate and disaster risks.

- b) Subproject appraisal
 - i. Support the RIDF team in undertaking preliminary assessments of subnational governments' financial, borrowing capacities, and initial screening of subproject technical proposal as well as environment and social safeguards;
 - ii. Support the RIDF appraisal team to appraise at least the first few subprojects proposed to RIDF, as well as during the initial two-year period;
 - iii. Provide inputs to RIDF staff for the preparation of appraisal reports and board notes/presentation.

- c) Procurement
 - i. Support RIDF in its role to assist subnational governments in reviewing bid documents for works contracts, including the incorporation of the recommendation of the safeguards instruments to be implemented during construction;

- ii. Provide guidance to the RIDF team in post-qualification, qualification and bid evaluation criteria;
 - iii. Support RIDF in pre-bid meetings, in clarifying issues raised by prospective bidders, and in preparation of pre-bid minutes;
 - iv. Provide support to the RIDF team on monitoring and evaluation of procurement ex-post review.
- d) Subproject Monitoring
- i. Assist the RIDF team in identifying critical issues in Project implementation with respect to each subproject, and help in developing report formats for subproject site visits and monitoring;
 - ii. Assist the RIDF team in evaluating requests for subproject disbursements after analyzing the pre-disbursement and disbursement conditions of each subproject;
 - iii. Assist in preparation of MIS templates for Project monitoring across various stages of the life cycle of each subproject, i.e. subproject development, procurement, appraisal, implementation, etc.;
- e) Hands-on Support
- i. Analyze the key areas where the RIDF and PDF teams require additional support;
 - ii. Support the RIDF team in refining standard documentation guidelines as well as revising the standard operating procedures for subproject appraisal, risk management, procurement and monitoring, as needed;
 - iii. Assist the RIDF team in developing standard presentation formats for subprojects to be presented for board approval.

Table A4.1: Implementation Support Work Plan

Time	Focus	Skills Needed	Resource Estimate	Partner Role
First 12 Months	Focus on a, b, c, d	Finance & Risk (including safeguards); Municipal Finance; Procurement; Technical Expertise	US\$ 200,000	<ul style="list-style-type: none"> • Actively hiring new/required positions, if necessary; • Regularly conduct capacity building in project preparation and municipal infrastructure financing, etc.
12- 36 months	Focus on a, b, c, d, and e	Finance & Risk (including safeguards); Municipal Finance; Technical Expertise	US\$ 550,000	Provide sufficient number of staffs with the required classification;

Table A4.2: Implementation Support Team Composition

Position	Experience	Level of Effort
Project Manager	Graduate degree with at least 8 years' relevant experience	Fulltime
Support to Project Manager	First degree with 3-5 years of experience	Fulltime
Senior environmental specialist	Graduate degree with over 15 years of relevant experience	Part time
Senior social safeguards specialist	Graduate degree with over 15 years of relevant experience	Full time
Procurement specialist	Graduate degree with over 10 years of relevant experience	Full time
Project Development and Appraisal Expert	Graduate degree with over 15 years of experience	1 week every month
Finance and Risk Assessment Expert	MBA or Financial Expert with over 15 years of experience	1 week every month
Municipal Finance Specialist	Graduate degree with at least 8 years' relevant experience	1 week every month
Technical Experts (Water & Sanitation, Social Infrastructures, Transportation, Gender etc.)	Graduate degree with at least 8 years' relevant experience	On an as-needed basis. Cumulative inputs of all technical experts of about 6 months over a period of 1 year.
Civil Engineer		

Annex 5: Subnational Borrowing Constraints and RIDF's Role

Indonesia: Regional Infrastructure Development Fund Project (P154947)

Current Constraints to Subnational Government Finance

1. A number of important factors constrain the ability of subnational governments in Indonesia to access domestic bank loan and bond markets. Market-driven constraints to municipal debt issuance arise from the high cost of debt issuance, debt market volatility, and the absence of long-term debt instruments. Sector-driven constraints are due to differences in the financial accountability and transparency of subnational governments, relative to the expectations of lenders and investors who finance corporate debt. These constraints make it difficult for subnational governments to approach the capital markets on a standalone basis, and form the basic rationale for having RIDF as a centralized borrowing facility to meet the needs of subnational governments.

Market-driven Constraints

2. The bond market in Indonesia is small and costly for bond issuers. The total market size is only 15.4 percent of GDP, consisting mostly of government bonds; the corporate bond market is only 2.3 percent of GDP.¹⁹ A large proportion of government bonds is held by foreign investors, which increases the volatility of all bond interest rates. Trading in the secondary market is limited as bondholders—mostly institutional investors—prefer to hold to maturity.

3. The Indonesia Stock Exchange's data on listed corporate bonds for the period January 2014 to June 2015²⁰ show that most are in the two highest ratings categories of AAA and AA, with median coupon rates of 9.6 percent and 10.1 percent, respectively. Rates for these two categories, taken together, ranged from 8.25 percent to 11.75 percent. This range of 350 basis points is unusually wide, even in emerging markets. These borrowing costs are often influenced by familiarity and frequency in the market, even for highly rated entities. So for a given rating category, corporations that issue bonds frequently in the market have a lower coupon rate than corporations that are new or infrequent to the market. Table A5.1 below shows the range and median coupon rates for actual corporate bond issues during the same period, by rating category.

Table A5.1: Coupon Rates (percent) of New Corporate Bond Issuances on IDX, 2014-2015

Rating Category	Lowest	Median	Highest	Range (percentage points)
AAA	8.25	9.60	11.00	2.75
AA	8.50	10.07	11.75	3.25
A	9.10	11.00	13.00	3.90
BBB	11.50	12.00	14.25	2.75

Source: Indonesia Stock Exchange

¹⁹ Finance & Markets, Capital Market Update, Capital Market Overview, World Bank, June 2015.

²⁰ Indonesia Stock Exchange, Indonesia Bond Market Directory 2014-2015, period covering January 2014-June 2015, <http://www.idx.co.id/index-En.html>

4. The bond market also does not currently support long-term debt for corporate issuers. Although the central government has attempted to support a yield curve by issuing bonds of different maturities, a review of Indonesia Stock Exchange data on corporate bond issuance in 2014 shows that maturities ranged from 1 to 7 years, with a median of only 3 years. So even if the bond market were to be receptive to subnational government issuers, the maturities would not match the asset life of the infrastructure being financed by subnational governments.

5. The commercial banking sector is larger than the bond market, and lending to the non-financial corporate sector has risen sharply in recent years. Bank loan rates have a slightly lower interest rate than bonds; the current median corporate lending rate by domestic and international banks is 9.75 percent, according to the central bank, Bank Indonesia (BI).²¹ However, as with corporate bond rates, bank lending rates have a large range—from 7.11 percent to 12.69 percent, with a prominent bank such as Bank Mandiri offering corporate lending at 10 percent.

6. Banks limit their exposure to shorter maturity lending in order to manage asset-liability mismatch; over 85 percent of Indonesian bank deposits are of less than one month's maturity. Even if the rate is fixed for the life of a loan, the short maturities mean that loans act as variable rate debt from a refinancing perspective, which creates additional budgetary exposure for subnational governments.

Sector-driven Constraints

7. The legal framework for subnational governments is evolving in a positive way, particularly under Law 23/2014 on Regional Governments, which provides greater clarity for intergovernmental roles and oversight, subnational government responsibilities and debt issuance. In the latter case, the law no longer distinguishes between types of debt issuance, be it central government or bank loans, or bonds. Nevertheless, ambiguities in this legal and regulatory framework exist in relation to the issuance and security for municipal debt. Until the regulatory framework is further developed (as is anticipated under the revision of Law 33/2004), and related regulations among ministries and securities regulators are harmonized, the capital markets will have difficulty in considering lending to subnational governments.

8. The current legal framework under Law 23/2014, Article 300, requires local legislative authorization for debt issuance, as well as formal recognition of scheduled debt service payments in the annual budget of the borrowing subnational government. These provisions are very positive from a debtholder perspective. Yet, while such government debt creates a budgetary obligation, it is unsecured since specific revenue or collateral pledges are permitted under Law 33/2014.

9. Increasingly, however, provisions are creeping into the regulatory language, that are neither common nor necessary for the issuance of unsecured debt obligations. For example, a provision in Government Regulation 30/2011 on Regional Borrowing states that amounts budgeted for annual debt service should be based on “revenues from activities financed by

²¹ Prime Lending Rate – Bank Sentral Republik Indonesia, www.bi.go.id/en/perbankan/suku-bunga-dasar, August 2012

regional bonds.” This regulation also states that bonds should be used to finance infrastructure investment that will generate revenues for the budget. While these project-specific user fees are available for debt service, they are not legally pledged. Nevertheless, this is a clear movement toward pledging revenue, since debt issuance under these provisions has a form of project revenue test. In addition, current provisions for a revenue test, fiscal capacity test, debt service coverage test and reserves are typical of secured municipal debt covenants in other countries.

10. A number of recent studies report that subnational governments have trouble submitting their budgets as required by the end of the calendar year, so their budgetary spending in the next year starts later than it should, resulting in unspent budgetary allocations each year.²² This is especially true for spending on capital projects, where BI reports that on average, end of year spending by subnational governments is 89 percent of what had been budgeted.²³

11. Subnational governments have improved their ability to produce financial reports, but issues remain as to their timeliness, quality and comprehensiveness. A significant number of these financial reports are still filed late.²⁴ Audits of subnational governments have resulted in a large number of qualified audit opinions or disclaimers. These issues act as a further constraint on subnational government access to capital markets.

12. Given current conditions, bonds have yet to be issued by subnational governments in Indonesia, although some have the financial capacity and the stated intention to do so. In the meantime, subnational governments have only accessed market financing for infrastructure through commercial banks, particularly from regional development banks (BPDs) that they typically own some shares in. Reliance on commercial banks is high, especially for pre-financing and short-term infrastructure projects, but not for medium and long-term financing.

Context: Indonesia’s Financial Sector

13. Banking dominates the growing Indonesian financial sector, controlling nearly 80 percent of its assets (see Figure A5.1 below). Overall, assets of banks and non-bank financial institutions (NBFIs) have grown substantially since the global financial crisis, from IDR 2,942 trillion or 59.4 percent of GDP at the end 2008, to IDR 7,459 trillion or 70.8 percent of GDP in early 2015. In August 2015, there were 118 commercial banks (including 4 SOE banks and 26 regional development banks) and roughly 1,644 rural banks in Indonesia. NBFIs consist of pension funds, insurance companies, mutual funds, and other financing institutions including venture capital, leasing companies, pawnshops, and microfinance institutions. Of these, insurance and financing companies are the two largest groups of NBFIs in terms of assets.

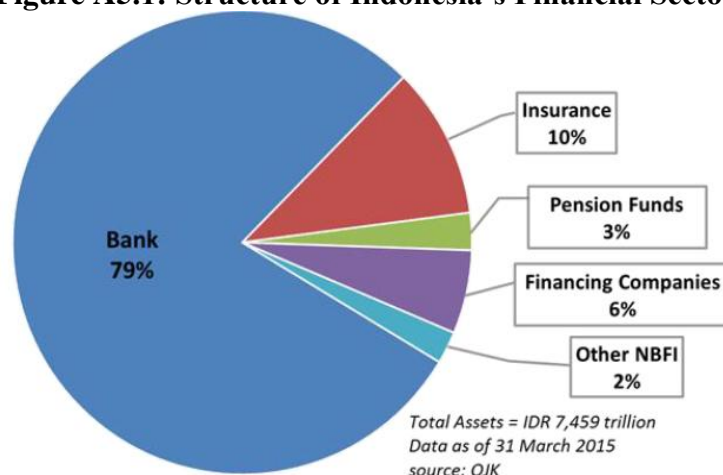
²² Good Governance Brief, Local Government Financial Management Reform in Indonesia, USAID, No. 3, September 2007, <http://pdf.usaid.gov/pdfdocs/Pnadq128>

²³ 2014 Economic Report on Indonesia Fortifying Stability, Accelerating Structural Reforms, Bank of Indonesia, 2014, www.bi.go.id/en/publikas/laporan-tahanan/perekonomian

²⁴ Public Sector Financial Management Reform: A Case Study of Local Government Agencies in Indonesia,” Monir Mir and Wahyu Sutiyono, University of Canberra, Australasian Accounting, Business and Finance Journal, Volume 7, Issue 4, Article 7, 2013, <http://ro.uow.edu.au/cgi.viewcontent.cgi>

14. Recent shifts in the regulatory system for Indonesia’s financial sector are largely complete. Previously, BI regulated and supervised the banking sector, while the capital market and NBFIs were supervised by the independent Financial Services Authority (OJK) which had its origins in MOF as *Bappepam-LK*). Since 2014, supervision of the banking sector is also now largely carried out by OJK. Currently, OJK is responsible for micro-prudential banking regulation, while BI maintains macro-prudential functions. In practice, BI continues to perform certain functions, notably in the financial services inclusion agenda and in payment systems that involve the financial sector.

Figure A5.1: Structure of Indonesia’s Financial Sector



15. Indonesia has a market-based interest rate regime, with certain controls on banking institutions but not for NBFIs. Market interest rates are benchmarked and set on the basis of the discount rate of the Bank Indonesia certificate (SBI); specific lending rates are freely established by banks based on market rates. Big players, whose shares are mostly owned by the government, have implicit market power to set high lending rates. BI and OJK manage this by encouraging competition and transparency, requiring big banks to publish their lending rates. There are no controls on NBFIs’ lending rates, as they do not accept deposits. Moreover, the deposit insurance agency (LPS) sets a rate periodically that determines which deposits are eligible for coverage by the deposit insurance scheme. Deposits carrying interest rates above the threshold rate are not covered.

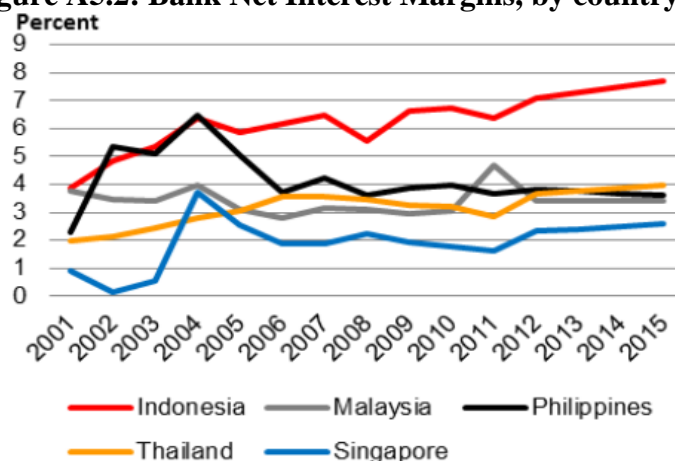
16. Third-party funds in Indonesia are costly and disbursed at higher cost to borrowers. The over-fragmentation of the banking sector, domination of a few large banks, and shallowness of the financial market drive up interest rates, as banks compete for third-party fund placements. Interest rates for local currency savings and demand deposits average 1.99 percent and 2.34 percent per annum, respectively. For time deposits, average interest rates range from 6.67 percent per annum for a one-month time deposit, to 8.61 percent for placements of over 1 year.²⁵ On the other hand, Indonesian lending financial institutions are not the most efficient, as measured by the ratio of operating expenses to total assets, which ranges from 2.5 percent to 4

²⁵ Bank Indonesia. 2015. Statistik Perbankan Indonesia, Agustus 2015. Jakarta: Bank Indonesia.

percent at the country’s biggest lenders (compared to 2 percent in Malaysia, and 1 percent in Singapore).

17. This inefficiency is paid for by driving up the net interest margin (NIM) or the spread between the interest rate charged to borrowers and the interest rate paid to fund owners.²⁶ Indonesia has one of the highest NIMs in the region (see Figure A5.2), on top of the BI benchmark rate that is already quite high given the country’s strong inflation expectations. At the end of the day, all of these factors subject borrowers—both corporates and individuals—to high borrowing rates.

Figure A5.2: Bank Net Interest Margins, by country



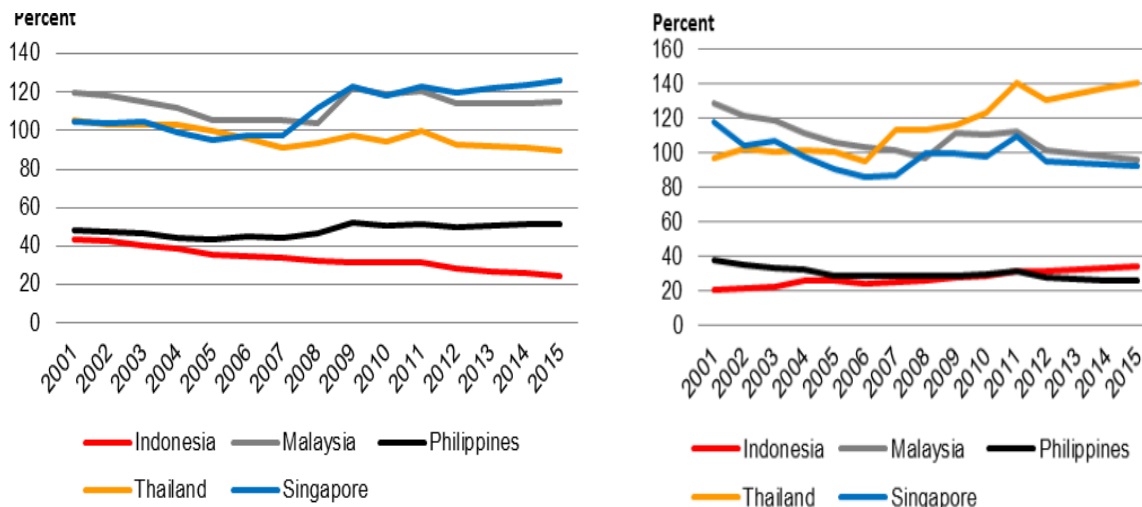
Source: World Bank Global Financial Development Database. Figures for 2012-15 are projections.

18. The banking sector suffers from asset-liability mismatch, growth is constrained by a lack of liquidity. The deposit base is largely short-term (~1 month) and the size relative to GDP is less than 30 percent, the lowest in the region (see Figure A5.3). There is lack of supply for longer-term funds due to the shallowness of Indonesia’s financial market, where shadow banking still reigns in a largely cash-based society. At the same time, the loans-to-funding ratio is capped at 94 percent; exceeding this limit is only allowed if a bank’s combined Tier 1 and Tier 2 capital exceeds a certain percentage of risk-weighted assets²⁷. All this has resulted in Indonesia having the lowest loan-to-GDP ratio in the region (see Figure A5.4).

Figure A5.3: Ratio of Deposits to GDP Figure A5.4: Ratio of Total Loans to GDP

²⁶ López-Espinosa, G., Moreno, A., de Gracia, F.P., 2011. Banks’ net interest margin in the 2000s: A macro-accounting international perspective. *Journal of International Money and Finance* 30, 1214–1233.

²⁷ Bank Indonesia Regulation No. 17/11/PBI/2015 issued on June 25, 2015.



Source: World Bank Global Financial Development Database. Figures for 2012-15 are projections

19. More broadly, the capital market in Indonesia is not highly developed, and is dominated by equity securities transactions. Equity market capitalization reaching IDR 5,147 trillion or around 51percent of GDP in 2015. Transactions in the shares of state-owned enterprises (SOEs) dominate the market; in 2015, 20 SOEs listed in the bourse accounted for 27 percent of market capitalization. Market players are mostly corporate and institutional investors such as mutual funds and pension funds with a preference for companies with large capitalization. Foreign investors are active in the market, and influential in determining market movements.

The Role of RIDF

20. Given the above, RIDF would play an important role in providing long-term debt to subnational governments in Indonesia for infrastructure finance, at a relatively lower cost of capital, where no such facility currently exists. As a centralized borrowing facility with an independent board and commercial lending standards, RIDF would foster an environment in which the institutional capabilities of subnational governments to plan and implement projects, as well as issue and service debt, would be developed. It can include provisions in its loan agreements that will strengthen subnational government capabilities, such as on budgeting, financial controls and project management. RIDF would not crowd out capital, since a subnational government debt market does not yet exist; rather, it provides opportunities for the creation of capital.

21. In the medium to long term, RIDF would also act as a bridge towards the development of a municipal debt market in Indonesia. Some subnational governments can be expected to diversity their sources of financing, by borrowing from other sources in addition to RIDF, for different types of projects. Some may eventually graduate from RIDF borrowing, accessing the debt markets on a standalone basis. On the other hand, RIDF would still have a long-term role to serve the infrastructure financing needs of smaller and weaker subnational governments with no other means of long-term borrowing. Overall, RIDF would serve a much broader subnational government client base than the bond market. and

22. The evolving legal and regulatory framework subnational borrowing in Indonesia, the limited institutional capabilities of subnational governments, and current financial market constraints in the country, mean that RIDF has a clear role to play in financing infrastructure among subnational governments. Work should also continue on harmonizing regulations for a municipal bond framework, as well as in strengthening the institutional skills of subnational governments to plan projects and to issue their own debt.

Annex 6: Effective Demand to Borrow, and RIDF's Potential Project Pipeline

Introduction – Effective Demand to Borrow

1. In the past, subnational governments in Indonesia could only access debt via on-lending mechanisms through MoF administered schemes. As such, the debt portfolio was dominated by foreign currency-denominated and supply-driven projects, where multilateral agencies were the only sources for loans, and the priorities of subnational governments were not driving lending decisions. Post-decentralization reforms have opened up the possibility of new avenues for subnational governments to access broader sources of financing e.g. municipal bonds, PPPs, and direct loans from commercial banks, but progress in these areas has been very limited.

2. In the aftermath of the 1997-98 Asian financial crisis, regulatory reforms were undertaken to address the issue of subnational borrowing. Several laws and regulations, such as Law 23/2014 on Regional Governments, Law 33/2004 on Intergovernmental Fiscal Relations, and Government Regulation 30/2011 on Regional Borrowing, have laid out a more comprehensive framework for subnational borrowing. Given the current environment, there is a great need for lending to meet municipal needs without imposing unlimited liabilities on GoI.

3. The growth of subnational borrowing depends on the effective demand for such borrowing—defined as willingness to borrow supported by borrowing capacity. To analyze the effective demand to borrow from RIDF, a combination of top-down and bottom-up approaches was used. Under the first approach, 15 subnational governments were first surveyed on their future infrastructure investments, as part of a market assessment. In addition, consultations with 10 subnational governments were held through two regional workshops, to explore their investment priorities²⁸. The second approach involved analysis of proposals submitted by subnational governments to PT. SMI. In general, almost all the subprojects put forth by subnational governments, through either approach, are listed in their respective RPJMD/RPI2JMD plans (investment plans), and agreed by their respective local legislatures. Subnational governments have also identified projects to be financed from other (conventional) sources, i.e. own-source revenues or intergovernmental transfers.

RIDF Potential Subproject Pipeline (Top-down Selection Process)

4. The top-down approach to identify the subproject pipeline consisted of three stages, which are described below. Figure A6.1 summarizes the methodology that was used.

5. As part of the first filter, 78 subprojects were identified in 18 subnational governments across Indonesia. The total investment value for these subprojects is around US\$ 4.97 billion. These subnational governments were selected based on the following criteria: i) coverage of all regions of Indonesia to the greatest extent possible; and ii) inclusion of both large and medium-sized subnational governments; and iii) sufficient fiscal and borrowing capacities of each

²⁸ In total, 18 subnational governments were covered through the market assessment and the two workshops, organized on June 5th and September 12th, 2015, to identify subnational governments' "wish list" of projects and their readiness.

subnational government. This will give the Project a degree of geographic concentration and scalability in the number of subnational governments covered, while also allowing some diversity across Indonesia’s regions. The 18 subnational governments consist of 14 cities, three regencies, and one province, as summarized in Table A6.1 below.

Figure A6.1: Project Pipeline Filtering Process

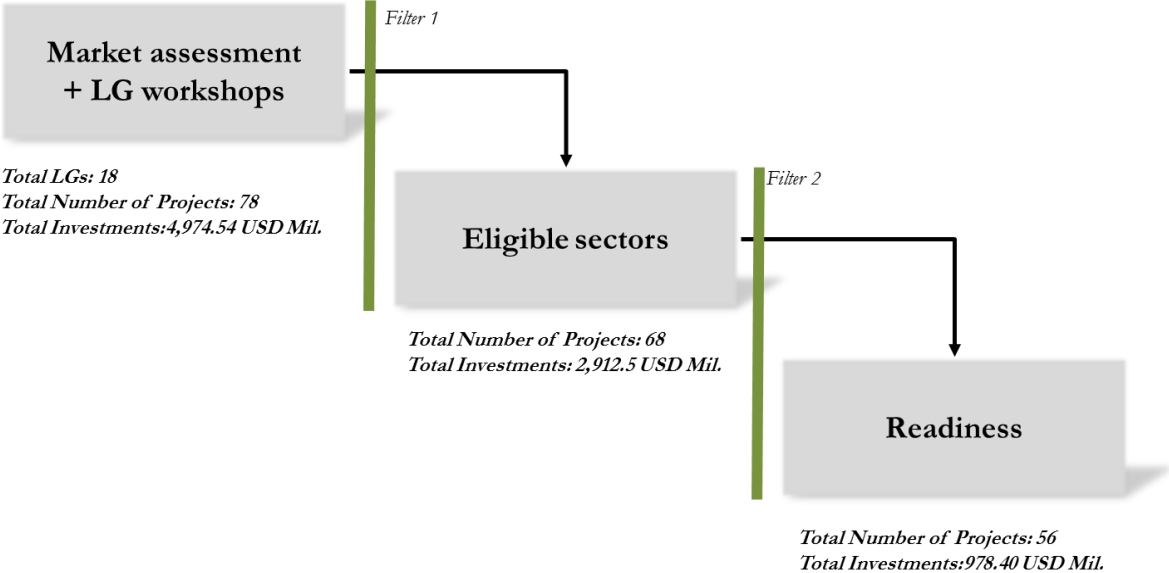


Table A6.1: Selected 18 Subnational Governments

1	East Kalimantan (Province)	10	Yogyakarta (City)
2	Sorong (Regency)	11	Bangka (City)
3	Bitung (City)	12	Sidoarjo (Regency)
4	Bogor (City)	13	Gresik (Regency)
5	Batam (City)	14	Balikpapan (City)
6	Semarang (City)	15	Banjar (City)
7	Denpasar (City)	16	Surabaya (City)
8	West Lombok (City)	17	Makassar (City)
9	Pontianak (City)	18	Surakarta (City)

6. The second step involved screening out subprojects that are not eligible for RIDF financing, due to criteria such as the financing ceiling or sector eligibility. So for example, two subprojects proposed by East Kalimantan province, for Samarinda Airport and the Balikpapan–Samarinda Toll Road, were excluded. The application of this second filter trimmed the number of subprojects down to 68, with a total investment value of US\$ 2.5 billion. Subprojects in water supply and sanitation, comprised the largest sector at almost half of total investment value. The roads sector was second. Table A6.2 summarizes the investment value of this set of subprojects, by subnational government and sector.

Table A6.2: Subproject Pipeline Based on Eligibility Criteria, US\$ millions

	Water Supply	Sewerage	Solid Waste	Roads	Health & Education	Transport	Other	Total
Sorong	6.1	-	-	57.6	-	-	-	63.7
East Kalimantan	10.0	-	-	411.9	-	-	-	421.9
Bogor	38.2	3.6	3.6	-	-	-	-	45.4
Batam	-	106.1	58.1	41.6	-	-	64.3	270.1
Semarang	-	-	-	71.4	-	-	50.0	121.4
Denpasar	228.6	-	8.4	-	14.3	-	-	251.3
West Lombok	3.6	-	-	0.1	-	-	-	3.7
Pontianak		-	0.6	58.1	-	-	-	58.7
Yogyakarta	2.5	5.0	-	-	-	-	-	7.5
Bangka	-	-	107.4	1.1	-	-	3.9	112.4
Sidoarjo	30.3	2.4	-	0.2	-	-	-	32.9
Gresik	143.0	-	-	7.1	-	-	-	150.1
Bitung	-	-	-	-	-	-	-	-
Balikpapan	50.9	101.6	2.5	226.7	-	-	-	381.7
Banjar	7.1	-	-	-	-	2.9	4.3	14.3
Surabaya	-	8.6	-	-	228.6	-	8.6	245.8
Makassar	-	224.1	-	3.21	-	-	-	227.3
Surakarta	-	93.6	-	-	-	-	-	93.6
Total	520.3	544.9	180.6	879.0	242.9	2.9	131.1	2,501.8

7. After the filtering processes above were applied, the remaining subprojects were assessed against a set of readiness indicators, based on the completeness of appraisal steps. Of the 68 potential subprojects, only 18 were categorized as having had partial or full appraisal done. The other subprojects had lower levels of readiness. Table A6.3 summarizes the 68 subprojects based on their readiness level, with an index value of 1 indicating the highest level of readiness, and 5 indicating the lowest.

Table A6.3: Readiness Level of Subprojects

No.	Readiness	No. of Subprojects	Investment Value (US\$ millions)
1	Full Appraisal – All project documents are ready, and lending can be proceed immediately.	0	0
2	Full Appraisal, Needs Update – All project documents prepared, but in need of update or revalidation.	1	10.0
3	Partial Appraisal – FS, DED or EIA underway or need to be prepared.	18	968.4
4	Appraisal Initiated – process started but needs assistance to complete.	13	772.5

No.	Readiness	No. of Subprojects	Investment Value (US\$ millions)
5	Identification – All appraisal activity yet to begin.	36	1,161.4

8. Table A6.4 shows the resulting pipeline of subprojects, comprising 18 subprojects across 10 subnational governments. Similar to results from the previous step in this filtering process, water supply and sanitation, and roads, remain the two largest sectors by investment value. The 10 subnational governments cover most of Indonesia's major island groups, i.e. Sumatra, Java, Kalimantan, Bali and Nusa Tenggara, as well as Papua, with an estimated total investment value of US\$ 567.5 million.

Table A6.4: Potential Project Pipeline: 18 Projects in 10 Subnational Governments

No	Sub-national Govt	Subproject Description	Sector	Amount (US\$ millions)
1	Sorong	Construction of roads and drainage of Arar Industrial Park (26 km x 25 km)	Roads, drainage	57.57
2	Bogor	WTP 2x300 l/s and reservoir capacity 4,000 m ³	Water supply	11.43
3		Development of network and pipeline replacement		10.00
4		Construction of networks for 4,200 new connections (offsite system of WWTP Paedang), and Integrated Waste Water Treatment Plan (IPLT)	Sewerage	3.57
5	Batam	Construction of Flyover at Kabil Junction (425 m) and Jam Junction 150 m)	Roads	41.57
6	Semarang	Construction of Semarang Outer Ring Road West-South, Semarang North Trace Outer Ring Road (road along beach), Semarang Trace Outer Ring Road East	Roads	71.43
7	Denpasar	Wangaya Regional General Hospital (RSUD): Rehabilitation, and financing the procurement of medical equipment	Health	14.29
8	West Lombok	Construction of intake well 300 l/s, WTP, 4.7 km transmission network, 5.13 km distribution network, 30,000 household connections	Water supply	3.57
9	Yogyakarta	Rehabilitation of Drainage (MSRAP)	Drainage	5.00
10	Sidoarjo	Increase WTP capacity 1,250 l/s for servicing 88,000 new connections	Water supply	27.93
11	Gresik	Construction of road (31.2 km)	Roads	7.14
12	Balikpapan	Construction of Ulu – Karingau Bridge	Bridge	70.60
13		Construction of Outer Ring Road 2 (Sepinggian Baru – Soekarno Hatta KM 8)	Roads	15.81
14		Improvement of City Roads and Settlement Roads		90.64
15		Construction of Beruang Madu Flyover		10.93
16		Construction of Muara Rapak Flyover		18.50
17		Construction of Coastal Road Segment II		20.21

No	Sub-national Govt	Subproject Description	Sector	Amount (US\$ millions)
18		Normalization of Ampal River, Normalization of Primary Drainages, and Revitalization Settlement Drainage and Construction of Bendali	Drainage	87.29
Total				567.48

RIDF Potential Pipeline (Bottom-up Selection Process)

9. In parallel with the top-down identification process described above, PT. SMI has also received approximately 32 applications from subnational governments with a total investment value of US\$ 453.9 million (see Table A6.5 below).

Table A6.5: Subprojects Proposed by Subnational Governments to PT. SMI

No.	Subnational Government	Sector	Amount (US\$ millions)
1	North Kolaka regency	Roads and bridges	7.4
2	Donggala regency	Hospital	14.4
3	Central Sulawesi province	Hospital	15.0
4	Katingan regency	Hospital	18.8
5	Pidie regency	Traditional Market	9.0
6	Polewali Mandar regency	Hospital	22.6
7	North Tapanuli regency	Traditional Market	22.9
8	South Halmahera regency	Traditional Market	5.3
9	Payakumbuh city	Hospital	7.5
10	Raja Ampat regency	Roads and bridges	15.5
11	Samarinda city	Drainage	12.5
12	Sidoarjo regency	Roads and bridges	14.5
13	Lubuklinggau regency	Roads and bridges	15.8
14	North Lombok regency	Roads and bridges	8.3
15	Sumbawa regency	Roads and bridges	13.5
16	Kutai Kartanegara regency	Roads and bridges	14.0
17	West Tulang Bawang regency	Roads and bridges	22.6
18	Sumedang regency	Hospital	3.0
19	Southeast Sulawesi province	Roads and bridges	7.5
20	Balikpapan city	Roads and bridges	18.0
21	Baubau city	Roads and bridges	7.0
22	West Lampung regency	Roads and bridges	15.0
23	Musi Rawas regency	Hospital	20.7
24	Tabanan regency	Hospital	22.6
25	Central Sulawesi province	Hospital	15.0
26	Semarang city	Roads and bridges	13.0
27	Denpasar city	Water	13.0

No.	Subnational Government	Sector	Amount (US\$ millions)
28	Makassar city	Sewerage	20.0
29	West Lombok regency	Water	11.0
30	Badung regency	Roads and bridges	16.0
31	Bogor city	Water	14.5
32	Batam city	Sewerage	18.0
Total			453.9

10. Of these 32 proposals, PT. SMI has undertaken screening and identified five as ready for financing. Table A6.6 below summarizes the readiness level of the 32 proposals, with two subprojects at the highest level of readiness. These subprojects are spread across the islands of Sulawesi, Sumatera, and Bali, with a total investment value of US\$ 86 million. Another 21 subprojects have a medium level of readiness, with partial appraisal done.

Table A6.6: Readiness Level for the 32 Proposed Projects

No	Readiness	No. of Subprojects	Amount (US\$ millions)
1	Full Appraisal – All project documents are ready, and lending can be proceed immediately.	0	0
2	Full Appraisal, Needs Update – All project documents prepared, but in need of update or revalidation.	2	14.9
3	Partial Appraisal – FS, DED or EIA underway or need to be prepared.	21	312.2
4	Appraisal Initiated – process started, but needs assistance to complete.	9	126.8
5	Identification – All appraisal activity yet to begin.	0	0

Conclusion – RIDF Combined Potential Subproject Pipeline

11. Based on a combination of the top-down and bottom-up pipeline identification processes described above, it can be concluded that effective demand exists among a considerable number of subnational governments. The information gathered from the market assessment, regional workshops and directly from the subnational governments reflects a high level of demand from subnational governments for infrastructure financing. Table A6.7 below synthesizes the top-down and bottom-up demand, and summarizes the status of those subprojects that are assessed to be most likely to be ready during the early stages of Project implementation.

Table A6.7: Potential Subprojects Expected to be Ready Early in RIDF Implementation

No	Name	Sector	Amount (US\$ millions)	Current Status
1	Payakumbuh	Hospital	7.5	Finalization of FS and DED; EIA prepared, Land cleared
2	Sidoarjo	Road	14.5	FS, DED, and EIA need update. Land cleared
3	W.Tulang Bawang	Road	27.6	FS and DED are prepared
4	Bogor	Water	14.5	FS and DED are prepared

5	N. Tapanuli	Market	22.9	FS and DED need to be updated
6	W. Lampung	Road	15	Preparation of FS and DED
7	N.Penajam Paser	Road	23.3	Preparation of FS and DED
8	Balikpapan	Road	18	Preparation of FS and DED
9	Sumbawa	Road	13.5	Preparation of FS and DED
10	Central Lampung	Road	53.8	Preparation of FS and DED
Total			210.6	

Annex 7: Financial and Institutional Assessment of PT. SMI

Indonesia: Regional Infrastructure Development Fund Project (P154947)

1. As part of Project preparation, an assessment of PT. SMI's financial and institutional capacities was undertaken, in order to assess PT. SMI's readiness to operate RIDF and the PDF. This assessment has informed the assessment of risks of this Project that have been discussed elsewhere in this PAD. The findings of this assessment have also fed into the Project design, including for the identification of areas of focus for the World Bank's implementation support to PT. SMI. This annex summarizes the findings of this assessment, and is structure into two broad sections, first on financial aspects and then on institutional aspects.
2. Since its inception in 2009, PT.SMI has shown stable growth by expanding its product and service offerings and diversifying its sectoral and geographical coverage. The portfolio of loans and advances is fairly diversified across infrastructure sectors including electricity, telecommunications, roads, transport, water supply, irrigation, and oil and gas. Total assets have grown at a compound annual growth rate (CAGR) of 44 percent, from IDR 2,121 billion (US\$ 170.5 million) in FY 2010 to IDR 9,170 billion (US\$ 737.1 million) in FY 2014, with loans and advances accounting for a major portion of total assets. PT.SMI has maintained a sufficient proportion of total assets in cash, and cash equivalents, and marketable securities which are likely to have a zero risk weighting.
3. The major source of financing for PT. SMI has been equity capital infused by GoI from time-to-time to ensure sufficient capital in line with the growth of the loan book, and borrowings from multilateral agencies. The company has received capital injections four times, with IDR 1 trillion (US\$ 80.4 million) at inception, another IDR 1 trillion in FY 2010, IDR 2 trillion (US\$ 161 million) in FY 2012, and most recently a further IDR 2 trillion in FY 2015. During FY2012-2014, borrowing from GoI for on-lending to IIFF accounted for a major portion of total liabilities. PT. SMI is a non-bank financial institution (NBFI) that is fully subject to all relevant regulations of OJK (Indonesia's Financial Services Authority).
4. PT. SMI has also diversified its borrowing portfolio by raising debt from the capital market through the issuance of bonds worth of IDR 1 trillion (US\$ 80.4 million) in FY 2014. The company has also raised debt through a US\$ denominated syndication facility from a consortium of commercial banks led by Standard Chartered, worth of US\$ 175 million in FY 2014. PT.SMI achieved a local rating of AA+ with a stable outlook for its rupiah denominated bond issuance in FY 2014, and a global rating of BBB- which reflects the sovereign rating.
5. Income from PT. SMI's operations is contributed by four sources: interest income, treasury income, income from advisory services, and income from project preparation support. Interest income accounts for a major portion of the income from operations; this stood at 51 percent in FY 2012, rising to 70 percent in FY 2014. Total revenues have grown at a CAGR of 64 percent, from IDR 82 billion (US\$ 6.6 million) in FY 2010 to IDR 598 billion (US\$ 48.1 million) in FY 2014.
6. The major contributors to PT. SMI's operating expenses are interest expenses and impairment loss provisions, business development expenses, and general administration

expenses. Impairment loss provisions have grown in line with the growth in the loan book, accounting for 4 percent of total operating expenses in FY2012 and increasing to 21 percent in FY2014. As of September 2015, NPLs stood at IDR 205.6 billion, constituting 3.3 percent of the loan portfolio excluding IIFF loans, or just 2.2 percent of the loan portfolio including IIFF loans. These NPL ratios are comparable to the average for Indonesian banks with infrastructure lending portfolios (3.5 percent, according to BI's statistics for September 2014), as well as to similar institutions in other countries (e.g. IIFCL in India and KDB in the Republic of Korea, at 2 to 4 percent).

7. PT. SMI enjoys an operating profit margin of 50 to 60 percent, and a net profit margin of 40 to 50 percent. The operating profit and net profit margins are relatively high compared to the corresponding averages for the banking sector of 18 to 30 percent, and 15 to 20 percent, respectively. Table A7.1 below provides a summary of the financial statements and key financial ratios of PT.SMI for the last three fiscal years.

Table A7.1: Summary of Key Financial Statements of PT.SMI (FY 2012-2014)

	FY2012	FY2013	FY2014
Income Statement (IDR billions)			
Revenue	226	424	598
Operating Cost	107	168	313
Operating Profit	118	256	285
Other Income Net of Other Expenses	14	6	32
Profit Before Tax	132	262	317
Tax Expense	26	56	72
Net Profit	106	207	245
Balance Sheet (IDR billions)			
Loans and Advances	1,952	5,061	6,577
Investments	403	430	644
Total Assets	5,132	7,090	9,170
Borrowings and Other Liabilities	822	2,543	4,384
Total Equity	4,310	4,546	4,786
Total Liabilities	5,132	7,090	9,170
Key Financial Ratios (percent)			
Net Interest Margin	5.8	4.0	4.7
Operating Profit Margin	53	60	47
Net Profit Margin	47	49	41
Return on Assets	3.4	2.9	2.7
Return on Investment	4.3	3.8	3.5
Return on Equity	4.8	4.8	5.4
Operating Expenses to Operating Revenue Ratio	47.5	39.6	52.5
Debt to Asset Ratio	32.3	35.9	47.8

Source: Audited Annual Reports of PT.SMI

8. A financial assessment of PT.SMI has been undertaken based on its business plan from FY2015 to FY2019, following the consolidation of the PIP portfolio with PT.SMI. ROE and ROA for FY2015 onwards are lower than in FY2014. This is attributable to a significantly large increase in equity capital and total assets relative to the increase in net profit. Especially in FY2015, the additional equity raised has not been fully deployed to advance additional loans. Table A7.2 below summarizes the key projected financial indicators for PT. SMI from FY2015 to FY2019.

9. Risk management frameworks and processes are under continuous development and improvement at PT. SMI. In line with international good practice, a project risk rating tool based on S&P's Capital IQ templates has been recently introduced for new investment applications at PT.SMI. A Risk Register and a Risk Control Matrix tool are also under development with assistance from an external consulting firm, with implementation expected during 2016. PT.SMI also has an adequate management information system (MIS) and risk analytics unit. This unit undertakes functions such as risk management, data analytics and support, reviewing the consolidated risk management report, reviewing portfolio management and risk monitoring, and reviewing stress test and risk sensitivity analysis.

Table A7.2: Key Financial Indicators of PT.SMI (FY2015-FY2019)

Key Ratios (percent)	H1 2015	FY2015	FY2016	FY2017	FY2018	FY2019
ROE	5.0	2.0	4.2	4.5	4.0	4.7
ROA	2.4	1.6	3.3	2.7	1.7	1.4
Net Interest Margin	4.4	2.1	6.0	4.8	3.0	2.5
Operating Profit Margin	44.5	57.7	72.4	60.9	36.1	28.3
Net Profit Margin	36.0	45.9	55.6	46.8	27.8	21.8
Debt to Equity Ratio	104.5	23.0	22.4	61.0	124.5	210.4
Debt to Capital Ratio	51.1	18.7	18.3	37.9	55.5	67.8

Source: Analysis from business plan projections provided by PT.SMI

10. For appraisal and internal rating of subnational government financing at PT. SMI, a local subnational government rating tool has been developed with assistance from PEFINDO, an Indonesian rating agency. This tool was finalized in December 2015, and is being applied first to the PIP portfolio that has been incorporated into PT. SMI. It will subsequently be used for all new financing extended to subnational governments under RIDF. More generally, PT. SMI's basic appraisal methodology adopts a typical corporate banking approach based on specific lending norms, followed by an internal rating assigned by the Risk Management Team.

11. With respect to corporate governance practices, PT.SMI's governance framework is in line with Indonesian laws. PT. SMI follows directives issued by MoF, its sole shareholder. It also adheres to regulations on non-bank financial institutions issued by OJK, Indonesia's Financial Service Authority. PT. SMI has in place an independent audit committee to monitor compliance and the functions of the company as a whole. In addition, it has various sub-committees that aid in the decision-making processes of Board of Directors and Board of Commissioners. The company has implemented good corporate governance practices based on the implementation outline provided by the Ministry of State Owned Enterprises Decree No. PER-01/MBU/2011. The principles underlying the company's good corporate governance are transparency,

accountability, responsibility, independence and fairness.

12. PT.SMI has started to increase the staff base of its subnational government financing unit to enable it to cater to the subnational government financing projects arising on account of PIP and the expected establishment of RIDF. PT.SMI expects to strengthen its staffing and capabilities by adding around 100 employees and creating a new directorate for risk management.

13. PT. SMI is also strengthening its staffing and capabilities in relation to environmental and social safeguards. At present, PT. SMI is only able to produce 2 to 3 safeguards reports for its potential projects, per month. PT. SMI is currently focusing on ensuring that national standards related to safeguards are fully implemented as part of its operations. In addition, international standards on safeguards have been applied to projects that PT. SMI is co-financing with international agencies. Going forward, PT. SMI aims to adopt international standards from 2017, in so far as these are appropriate, reasonable and relevant to actual conditions that are encountered in Indonesia.

Annex 8: Economic and Financial Analysis

Indonesia: Regional Infrastructure Development Fund Project (P154947)

Introduction

1. The Government of Indonesia has set a goal for annual economic growth to reach 7 percent by 2019, and is increasing its spending on infrastructure. This expanded investment in infrastructure is expected to reduce logistics costs and promote domestic and international trade, facilitate better movement of people and goods, and increase productivity and quality of life.^{29,30,31} In this context, RIDF is an important building block in Indonesia's infrastructure development agenda, to promote equitable growth throughout the country.
2. Operated by PT. SMI, RIDF will provide local currency loans at affordable interest rates to subnational governments for investment in infrastructure. The economic analysis of potential subprojects to be financed by RIDF can only be undertaken after the establishment of RIDF and as part of RIDF's appraisal of such subprojects. Therefore, a framework approach has been developed for economic analysis at the subproject level, which will be used during Project implementation. This approach is described below. The financial analysis of RIDF, based on a set of projected financial statements underpinned by assumptions about RIDF's operations, are also described in a separate section below.

Economic Analysis

3. RIDF's Operations Manual will include a methodology for the economic analysis of subprojects. The general framework approach to be used for the evaluation of each subproject is based on conventional economic appraisal methodology. Specifically, it compares a "with project" scenario with a baseline "without project" scenario. For example, for a road subproject, the economic benefits expected would include reduced travel times and lower vehicle operating costs. In the case of a water supply subproject, economic benefits may include resource cost saving³² on the non-incremental water consumed in switching from alternative supplies to the new water supply system resulting from the Project, and willingness to pay estimated on the basis of the average price for incremental water consumed³³. The economic costs include construction costs, routine maintenance costs during operation, and environmental and social

²⁹ Weisbrod, G., & Treyz, F. (1998). Productivity and accessibility: bridging project-specific and macroeconomic analyses of transportation investments. *Journal of Transportation and Statistics*, 1(3), 65-79.

³⁰ Kemmerling, A., & Stephan, A. (2002). The contribution of local public infrastructure to private productivity and its political economy: evidence from a panel of large German cities. *Public Choice*, 113(3-4), 403-424.

³¹ Henderson, V. (2002). Urban primacy, external costs, and quality of life. *Resource and Energy Economics*, 24(1), 95-106.

³² Resource cost savings are estimated by multiplying the quantity of water consumed without the project by the average economic supply price in the without-project situation. For simplicity, it is assumed that the quantity of water consumed without the project is the same as the quantity of water consumed before the project. In cases where the before-project water is not paid in cash, the implied price can be estimated in terms of the opportunity cost of resources expended to obtain supplies of water.

³³ Asian Development Bank, (1999), "Guidelines for the Economic Analysis of Water Supply Projects", ADB, Manila.

costs including externalities. The analysis of economic costs and benefits enables the estimation of the economic internal rate of return (EIRR) and the net present value (NPV) of the subproject, in monetary terms.

4. Economic costs and benefits cannot always be reliably quantified and fully valued in monetary terms. In the absence of sufficient reliable data to evaluate benefits in monetary terms, an alternate method of evaluating cost-effectiveness may be used. Both these methods should be supported by not only quantitative data but also with due consideration to the potential qualitative impacts.

5. Two examples are provided below of economic analysis for subprojects. The first example is a road project in the Province of Bali, and the second example is a public market in the Province of Aceh.

Box A8.1: Road Investment Subproject

There are several economic benefits from a road investment that can be measured and quantified such as reduced vehicle operating cost, saving travel time, reduced road maintenance cost, improved road safety, and increased economic activity. Due to data availability, we consider only three variables as a proxy to the economic benefits, those are vehicle operating cost (VoC); value of travel time (VoT); and value of increase in land values. All data comes from a Road Infrastructure Investment in *Gitgit – Wanasari*, District of Buleleng, Province of Bali and The Eastern Indonesia National Road Improvement Project (EINRIP). The project will finance the construction of road of 8.6 km length and 15m width. Project investment would have a service life of at least 10 years.

Estimation Model of Net Economic Benefit

$$\sum_{i=1}^n \text{Net benefits} = \left(\delta \sum_{i=1}^n (VoC + VoT + LV) \right) - \left(\delta \sum \text{Road Agency Cost} \right); \quad \delta = \text{Discount factor}$$

The model is built to calculate the reduced vehicle operating cost (VoC), time saving valued in money terms (VoT or value of travel time), as well as land value increase “with” and “without” the subproject. In other words, the total net economic benefits from road infrastructure investment thus are a sum of differences between benefit raised through the subproject. To calculate VoC, the team extracted information on costs (i.e. the fuel cost, lubricant cost, spare part cost, labor maintenance cost, depreciation, cost of capital and insurance) and use the PCI (Pacific Consultant International) estimation model. In addition, the representative types of vehicle used in this study are car, bus and truck. For the VoT, time value is proxied and monetized by half of the average passenger’s income multiplied by the number of passengers per vehicle. Information about number of passengers is obtained from several studies on Indonesian provinces.

In order to analyze the full economic benefits and costs, road agency cost data was included in the analysis to calculate net benefit (or net cash flow). Total social costs of road investment are road agency costs, covering the whole investment and maintenance, and road user costs (i.e. vehicle operation, passenger and cargo time, and accidents). Investment costs are the sum of construction, cost related to land acquisition and taxes. Moreover, we omit road user costs from the calculation because it is already included in VoC. Total investment cost for this subproject is 117.95bn Rupiah or equal to US\$ 9.073mn. Construction periods will be two years from 2016 to 2017, and divided into 2 phases. Phase 1 is Gitgit-Sukasada for 4.1 km and Phase 2 from Sukasada to Wanagiri for 4.5 km. The road is part of the access from Buleleng to Denpasar.

Table: Economic Benefit Analysis

Vehicle operating cost	Value of travel time	Increase in land value
Consumptions from three classes of vehicles with and without subproject	HH monthly expenditure in Bali	Total land area with increased value (sqm)
Costs with and without subproject	Average hourly wage	Increase in land value per sqm
Total length road	Passenger capacity * vehicles	Total increase in land value
Reducing VoC (= difference between cost with and without project)	Time savings per roundtrip for old and new road	Annual yield from land (percent)
Number of Vehicles and their growth	Value of time savings per roundtrip	Length of road
Total annual benefit from VoC saving	Total annual value of time saving	Total Annualized increases in land values.

The NPV of this subproject investments were then calculated over a period of 11 years (2016-2027). There will be no re-investment during this period of analysis. The discount rate used was 10 percent given reasonable estimates of the full lifetime costs and benefits associated with the subproject. The subproject NPV over 14 years, at a discount rate of 10 percent is estimated at US\$ 6,562,490.02, with an economic internal rate of return (EIRR) of 19 percent.

Sensitivity Analysis

The sensitivity of the subproject's net benefit was analyzed with respect to two key variables: an increase in social cost and a decrease in benefit. The following are some of the potential critical variables to be considered for sensitivity analysis: i) 10 percent increase in costs; ii) 10 and 20 percent decrease in benefit (for example due to high inflation). The result of sensitivity analysis reveal that the overall net economic benefit of road subproject are relatively insensitive to changes in either average costs or average benefit.

Table: Sensitivity Analysis

	Case 1 Cost +10%	Case 2 Benefit -10%	Case 3 Benefit -20%
NPV	5,602,162	4,945,913	3,329,337
EIRR	17.1%	17.0%	14.9%

Box A8.2: Public Market Subproject

Comprehensive economic analyses have been undertaken for a public market in Province of Banda Aceh. The analyses provide detailed insight into the direct and indirect economic impact of the market. The objective of this subproject is to revitalize Banda Aceh traditional market. Further, it is also aimed at increasing the competitiveness of traders in the traditional markets as well as creating more jobs for those living in Banda Aceh area. It is expected that the subproject will have a positive impact beyond the construction of the market. Since the market is located next to famous Baiturrahman Mosque which is in the middle of the city it will generate more economic activity³⁴. Total investment loan agreed and disbursed for this subproject is 42 billion Rupiah or equal to US\$3.23 million³⁵. The loan will be used for constructing new stores, kiosks, stalls, cafeteria and other supporting facilities. The disbursement schedule is 70 percent in Year 1 and 30 percent in Year 2. The financial benefit or revenue of the subproject was based fairly on conservative assumptions with respect to tariffs and occupancy rate. Revenue streams are assumed coming from several elements such as rent from kiosk, stalls, stores; parking retribution; toilette retribution; and advertising tax. The new market is built to accommodate around 255 traders. In order to analyze the full costs of the subproject, annual operating and maintenance (O&M) costs for the Banda Aceh traditional market investments under this Project were included in the analysis. Operational and maintenance costs for the market include waste management, cleaning service, building maintenance, personnel costs, and the cost for electricity and water. Project investments would have a service life of at least 10 years.

The economic benefit for this subproject does include benefits that are fairly less-complex to quantify such as change in the Office of Market Management’s revenue with and without the subproject, and average cost saving related to attracting customers due to lesser competition from street vendors and minimarkets. Meanwhile, the expected costs were obtained based on an actual cost burdened by traders and consumers at the market. The NPV of this subproject investments were then calculated for the subproject as a whole, over a period of 14 years (2014-2027). The subproject NPV over the above mentioned period of time, at a discount rate of 10 percent, is estimated at US\$ 3.153mn, with an internal rate of return (IRR) of 24.98 percent.

The sensitivity of the subproject’s net economic benefits was analyzed with respect to two financial variables and divided into three different scenarios. The first analysis is if there is an increase in operational and maintenance costs by 10 percent. Second and third scenarios are if there is a decline in revenue stream of 10 and 20 percent, respectively. The results of this sensitivity analysis are presented below in terms of three cases. The results of the sensitivity analysis reveal that the overall net benefits of the subproject are relatively insensitive to an increase of cost as well as considerable decreases in income. The main conclusion to be drawn from this analysis, therefore, is that the subproject is financially feasible given the three scenarios. The internal rates of return for the three cases are between 18.03 to 21.89 percent. These numbers are still above the determined discount rate.

Table 3: Sensitivity Analysis (USD)

Year	Case 1 Cost +10%	Case 2 Revenue-10%	Case 3 Revenue-20%
NPV	2,692,843	2,377,463	1,601,124
IRR	21.9%	21.6%	18.0%

³⁴ An integrated financial and economic analysis of the project is available separately.

³⁵ Assumption US\$1=Rp13,000

Financial Analysis

6. As part of the development of a robust business plan for RIDF, financial projections were made for the first 10 years of its operations. The projections were based on several assumptions, including the size of potential subproject investments, a maximum loan-to-value of 90 percent, available capital (up to US\$ 1 billion over 10 years, comprising of US\$ 500 million equity from GoI and US\$ 500 million from borrowing), an interest rate spread of 1 percent (which sets the lending rate at 9.25 percent based on a cost of borrowing of 8.25 percent), grace periods for borrowing and lending of up to 3 years, technical assistance costs (project preparation at 1 percent, and project management consultancy at 1 percent, of subproject value), and an exchange rate of IDR 13,500 per US dollar. Subprojects included in the analysis were drawn from the market demand assessment, projected over the next 7 years with phased expenditures. This phasing took into account the nature of engineering and construction complexity in each sector.

7. Three different scenarios for drawdown of RIDF's equity and debt were evaluated: (i) equity drawn first followed by debt; (ii) equity and debt drawn in equal proportion; (iii) debt drawn first followed by equity. The pattern of drawdowns has an impact on the profitability of RIDF, as measured by the net profit ratio. As shown in Table A8.1 below, RIDF's profitability improves if equity is drawn down first. On the other hand, return on equity (ROE) improves if debt is drawn down before equity. In all the three drawdown scenarios, the debt service coverage ratio (DSCR) indicator is well above 1, indicating a comfortable financial position in meeting debt service obligations.

Table A8.1: Impact of Various Drawdown Options on RIDF's Profitability

	Equity first, then debt	Equity and debt in equal proportions	Debt first, then equity
Average profit after tax (US\$ millions)	27	24	21
Net profit ratio (percent)	76	52	29
Return on equity (percent)	6	7	9
Debt service coverage ratio (DSCR)	2.4	2.7	1.4

8. A set of projected financial statements for RIDF was prepared based on the assumptions given above, including the balance sheet and the profit and loss statement. For these projections, the third drawdown scenario (i.e. debt first and then equity) was used. The projections estimate that RIDF's loan book would grow from US\$ 22 million in year 1 to as much as US\$ 872 million in year 5. Total assets are projected to reach more than US\$ 1.09 billion by year 10. Capitalization with debt starts from year 1, while injection of the equity portion begins from year 4. (See Table A8.2 for the projected balance sheet.)

Table A8.2: Projected RIDF Balance Sheet (in US\$ millions)

	Year									
	1	2	3	4	5	6	7	8	9	10
Assets										
Loans to subnational governments	22	138	340	584	784	862	895	828	753	671
Cash	-	-	1	17	88	182	169	246	329	416
Total Assets	22	138	341	602	872	1,044	1,064	1,075	1,082	1,087
Liabilities										
Equity	0	0	0	0	100	350	500	500	500	500
Retained Profits	0	0	1	10	37	74	116	149	180	206
Borrowings from central government	22	138	340	492	485	470	448	425	403	380
Total Liabilities	22	138	341	602	872	1,044	1,064	1,075	1,082	1,087

9. The projected profit and loss statement for RIDF is shown in Table A8.3. Profits are driven by interest income, which starts off low in the first few years, before growing strongly in line with growth in the loan portfolio. Interest income from loans represents more than 90 percent of the total interest income during the first 5 years.

Table A8.3: Projected RIDF Profit and Loss Statement (in US\$ millions)

	Year									
	1	2	3	4	5	6	7	8	9	10
Interest income from lending	2.07	12.7	31.4	54.1	72.5	79.7	82.7	76.6	69.6	62.1
Interest earned on surplus	0.02	0.14	0.34	1.43	3.77	5.39	7.23	8.56	8.94	9.04
Income earned on liquid assets/investments	-	-	-	0.64	4.5	8.86	8.86	-	-	-
Less: Interest payable	1.84	11.4	28.0	40.6	40	38.7	36.9	35.1	33.2	31.4
Operating income	0.25	1.52	3.74	15.8	40.8	55.3	61.9	50.1	45.4	39.7
Establishment costs	0.10	0.11	0.11	0.12	0.13	0.13	0.14	0.15	0.15	0.16
Other costs	0.14	0.89	2.20	3.78	5.08	5.58	5.79	5.36	4.88	4.34
Profit before tax	0.01	0.52	1.42	11.7	35.6	49.5	56.0	44.6	40.3	35.2
Income tax	-	0.13	0.36	2.92	8.89	12.4	14.0	11.6	10.1	8.8
Profit after tax	0.01	0.39	1.07	8.75	26.7	37.6	42.0	33.6	30.3	26.4
Dividends paid	-	-	-	-	-	-	-	-	-	-
Retained profit	0.01	0.39	1.07	8.75	26.7	37.2	42.0	33.5	30.3	26.1

10. Based on the above, the projected key financial ratios for RIDF during the first 10 years of its operation are shown in Table A8.4 below. These key ratios – on profitability and the returns on assets and equity – are healthy throughout the period.

Table A8.4: Projected RIDF Financial Ratios

	Year									
	1	2	3	4	5	6	7	8	9	10
Net profit ratio (percent)	1	3	3	16	37	47	51	44	43	43
Return on assets (percent)	0	0	1	1	3	4	4	3	3	2
Return on equity (percent)	0	1	7	8	7	6	7	5	4	4

11. The sensitivity of the RIDF's financial performance was analyzed with respect to two key variables: the net interest margin, and non-performing loans (the NPL ratio). The results of this sensitivity analysis are presented in Table A8.5 below in terms of switching values for the net profit ratio, i.e. the values of the selected variables at which the net profit ratio becomes zero. The results show that all else remaining equal, RIDF would be profitable starting from year 1 with a net interest margin of at least 0.65 percentage points. Likewise, RIDF would be profitable so long as the NPL ratio remains below 15 percent.

Table A8.5: Switching values of selected key variables

	Switching values with respect to the net profit ratio
Net interest margin	0.65 percentage points
Non-performing loan ratio	15 percent

Annex 9: Building Climate Resilience

Climate change vulnerability context of Indonesia³⁶

1. Many parts of Indonesia are highly vulnerable to multiple climate change hazards, including drought, floods, landslides, sea-level rise. The eastern and western portions of densely populated Java, the coastal regions of much of Sumatra, parts of western and northern Sulawesi, and southeastern Papua islands all rank highly in mapping of multiple climate hazards. In addition, Indonesia's location along the 'Pacific ring of fire' means that it is also exposed to a wide range of natural disasters, including earthquakes, volcanic eruptions and flooding.

2. Climate warming by itself is not the greatest risk; warming-related changes in wet and dry season rainfall, as well as extreme events, are the larger issue for Indonesia. More intense rainfall and sea-level rise are expected to adversely affect food security, health, water resources, farming and coastal livelihoods. Rainfall variability will negatively affect water resources, including the drinking water supply. Heavy rainfall with associated turbidity may water processing facilities, contaminate the water supply and increase the costs of water treatment. Sea level rise will threaten productive coastal zones and affect livelihoods. Low-lying coastal areas will be affected by rising seas, higher tides and storm events. More than 40 million Indonesians live within ten meters above the average sea level. Coastal cities such Jakarta, Semarang, and Surabaya are areas of great concern because of their high population densities.

3. Estimates suggest that by the end of this century, climate change will cost Indonesia between 2.5 and 7 percent of GDP. The greatest impacts will fall on the poorest people, specifically those who live in areas susceptible to drought, flooding or landslides and who are dependent on climate-sensitive livelihoods, particularly in agriculture and fisheries. Women and female-headed households are disproportionately represented among Indonesia's poor and are more susceptible to negative shocks from natural disasters, economic downturns, or climate-induced impacts.

Characterization of climate risks by subproject type

4. As described earlier in this PAD, RIDF will fund infrastructure investments by subnational governments across Indonesia. Climate risks will vary by subproject, depending on subproject type or sector, as well as on the location of each subproject. In terms of location, subprojects located in coastal areas or mountainous areas prone to landslides are more likely to be vulnerable to climate risks. In terms of sectors, subprojects in water supply are more likely to face climate risks than subprojects in social infrastructure like public markets, for example. Table A9.1 below summarizes some examples of climate risks by subproject sector type.

Framework approach for building climate resilience of RIDF subprojects

³⁶ The information contained in this section is largely drawn from the Program Document of the Indonesia Climate Change DPL, 2010 (Report No. 54238-ID), and the Climate Change Knowledge Portal's Climate Adaptation Country Profile for Indonesia (accessible through <http://sdwebx.worldbank.org/climateportal/>).

5. For physical infrastructure, including RIDF subprojects, considering future climate variability and change is critical to avoid “locking in” designs and features that are only suited to the current climate. For example, a road to be constructed in a flood-prone area may be designed with the highest expected flood levels based on the current climate, which may be inadequate for a future climate that may feature more extreme rainfall and flooding events. While the costs of “building better” may entail a higher upfront cost today, the benefits may outweigh the costs in terms of avoided damage to the infrastructure and associated reductions in property damage, injuries, and loss of life. That said, subnational governments in Indonesia operate in a financially constrained environment, where affordability and value for money are key. Therefore, in each case, a careful assessment of net benefits will be needed.

Table A9.1: Examples of Climate Risks by Subproject Sector/Type

Sectors		Examples of Climate Risks
1	Water Supply	<ul style="list-style-type: none"> • Droughts and lower average rainfall may reduce the quantity of water resources available for a water supply subproject. • Heavy rainfall with associated turbidity may strain water treatment facilities. • Flood events may affect water treatment plants and contaminate the water supply.
2	Sanitation	<ul style="list-style-type: none"> • Extreme flood events may affect wastewater treatment plants and networks, and inadvertent overflows may lead to the contamination of streams and rivers.
3	Drainage	<ul style="list-style-type: none"> • Heavy rainfall and associated runoff may overwhelm drainage networks, which may need to be built to provide a higher capacity to cope with future climate variability.
4	Housing and Slum Upgrading	<ul style="list-style-type: none"> • Housing units built in vulnerable areas like coastal locations or in steep terrain may need to be built to higher specifications so as to be resilient to the risks of sea-level rise, flooding and landslides. • Higher average temperatures and more frequent heatwaves may require improved house designs that allow for more airflow and natural cooling / shading.
5	Roads and bridges	<ul style="list-style-type: none"> • Roads in mountainous terrain or in coastal locations may be vulnerable to damage or destruction from landslides, flooding or storm surges. • Bridges may be damaged or destroyed from erosion of river embankments and very high volumes of river flow in the aftermath of extreme rainfall events.
4	Social Infrastructure, e.g. hospitals, schools and public markets	<ul style="list-style-type: none"> • Facilities located in coastal or mountainous areas or in steep terrain may need to be built to higher specifications so as to be resilient to the risks of sea-level rise, flooding and landslides. • Facilities may also be strained by more frequent extreme events, resulting in higher numbers of illnesses or injuries that require larger capacity hospitals for treating more patients, or larger school facilities to serve as temporary evacuation centers.

6. The actual assessment of climate risks for each RIDF subproject, and any subsequent strengthening of subproject designs to take account of such risks, can only be undertaken during Project implementation as part of the preparation of each subproject. Subprojects should be designed and implemented so as to be resilient to climate-related risks.

7. The existing system of environmental assessment in Indonesia does provide for the analysis and mitigation of disaster risks. Standard technical guidance on the evaluation of major environmental impacts includes analysis of the risks of natural disasters for areas in or near sources of such risk. This is also reflected in relevant government regulations; for example, Government Regulation 64/2010, on mitigating disaster risks in coastal areas and small islands, specifies the use of a range of structural and non-structural mitigation measures, including AMDAL and spatial plans as appropriate.

8. Given the above, a simple framework approach has been developed for climate and disaster risk screening at the subproject level, with reference to existing Indonesian technical guidance and regulations, and drawing on the World Bank's Climate and Disaster Risk Screening Tools³⁷. This approach is included in the Project's Operations Manual, for use by PT. SMI and subnational governments. The Project's Implementation Support Plan includes the delivery of training and the development of resource materials on this topic.

9. The basic steps in this approach are as follows:

- Exposure: Identification of climate and geophysical hazards that the subproject may face, including the extent of such hazards, both current and in the future. These include: extreme rainfall and flooding; drought; sea level rise; earthquake; and heatwaves.
- Potential Impacts: Assessment of potential impacts (e.g. high, medium or low) on the subproject during its operational life that affect its intended benefits/outcomes, as well as the level of risk (i.e. the likelihood of such impacts occurring).
- Adaptive Capacity: Consideration of how non-physical aspects such as operations and maintenance, emergency planning, access to technology, capacity building, and public awareness, may influence potential impacts.
- Resilience Measures: Identification of specific measures that can be incorporated into the design of the subproject (e.g. modifying the engineering design to reduce exposure and impacts), including the evaluation of the net benefits of doing so in relation to the incremental costs of such measures.

Climate change adaptation co-benefits

³⁷ <https://climatescreeningtools.worldbank.org/>

10. Given the framework approach of RIDF, it is not possible at this stage to give a precise quantification of the proportion of the World Bank financing under this Project that provides direct climate adaptation co-benefits. However, as part of the Project preparation process, a conservative estimate of the amount of the climate co-benefits has been made, using the following steps:

- First, it is assumed that the overall sectoral distribution of subprojects over the period of Project implementation will be similar to that of the existing potential pipeline, as described in Annex 6 (Table A6.2). Based on this assumption, road and bridge subprojects are expected to account for 35 percent of the total value of all subproject investments, while drainage and sewerage account for 22 percent, and water supply for 21 percent, respectively. The remaining 22 percent is distributed among other sectors such as health, education, public markets, and solid waste.
- For the purposes of deriving the co-benefits estimate, it is assumed that most of the co-benefits would occur in the three largest sectors mentioned above, i.e. roads and bridges, drainage, and water supply. Together, these three sectors are expected to account for 78 percent of the total value of subproject investments.
- However, to be conservative in the estimate, not all subprojects in these three sectors should be assumed to provide direct climate adaptation co-benefits. For example, the assessment of climate risks for a road subproject may not result in any specific resilience measures in the design and implementation of that subproject, if the road is located in an inland area that is not exposed to the risk of floods, landslides or other hazards. In this case, this subproject would not be counted as providing a co-benefit. Therefore, only half of subprojects in these three sectors are assumed to offer climate co-benefits.
- For each subproject, the specific adaptation-related measures to be incorporated into the subproject design cannot be determined at this stage. Simple assumptions have therefore been made on the “typical” average cost of such measures as a percentage of total subproject cost, for each sector: 8 percent for roads and bridges, 10 percent for drainage and sewerage, and 15 percent for water supply.

11. Based on the above, given the total World Bank financing of US\$ 100 million for Component 1, the amount that directly provides climate adaptation co-benefits is conservatively estimated to be close to US\$ 4.1 million, as summarized in the table below. The Project mid-term review and final evaluation would be able provide a more precise quantification of climate co-benefits, based on an assessment of the actual portfolio of subprojects, including the sector, location and nature of each subproject.

	Roads and bridges	Drainage and sewerage	Water supply	Total
Estimated total amount of Component 1 financing (US\$ millions)	35.00	22.00	21.00	78.00
Of which, half offer climate adaptation co-benefits	17.50	11.00	10.50	39.00

(US\$ millions)				
Adaptation measures as a percentage of a typical subproject's cost, on average (percent)	8	10	15	-
Amount of financing directly providing climate adaptation co-benefits (US\$ millions)	1.40	1.10	1.58	4.08