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March 27, 2017

**PROJECT DOCUMENT**

**OF**

**THE ASIAN INFRASTRUCTURE INVESTMENT BANK**

**Republic of Indonesia**

**Regional Infrastructure Development Fund Project**

**CURRENCY EQUIVALENTS**  
(Exchange Rate Effective 27 March, 2017)

Currency Unit = Indonesian Rupiah (IDR)  
US\$ 1 = IDR 13,333

**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
PT.SMI	<i>PT. Sarana Multi Infrastruktur</i> (A State-Owned Enterprise under Ministry of Finance for Infrastructure Financing)
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
SECO	Swiss Secretariat for Economic Affairs
SLA	Subsidiary Loan Agreement
SMBC	Sumitomo Mitsubishi Bank Corporation
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
WB	World Bank
WDP	<i>Wajar Dengan Pengecualian</i> (Qualified Audit Opinion)

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## 1. PROJECT SUMMARY SHEET

### Republic of Indonesia Regional Infrastructure Development Fund Project

Project No.	000012
Client Borrower(s) Implementation Agency	Republic of Indonesia PT. Sarana Multi Infrastruktur
Sector(s) Subsector(s)	Urban infrastructure
Project Objectives / Brief Project Description	<p>The project objective is to increase access to infrastructure finance at the subnational level through a sustainable financial intermediary.</p> <p>The project has 2 components, which include Component 1: Capital Support for RIDF and Component 2: Project Development Facility. Component 1 will cover the capital costs of the infrastructures, while Component 2 will help build a subproject pipeline for RIDF by supporting subnational governments in subproject identification, planning, and preparation.</p>
Project Implementation Period (Start Date and End Date)	Start Date: April 15, 2017 End Date: December 31, 2020
Expected Loan Closing Date	June 30, 2021
Project cost and Financing Plan	Project Total Cost: US\$406 million AIIB: US\$100 million World Bank: US\$100 million GOI: US\$203 million SECO: US\$3 million
AIIB Loan (Size and Terms)	US\$ 100 million with a final maturity of 10 years, including a grace period of 5 years at the Bank's standard interest rate for sovereign-backed loans
Co-financing (If any) (Co-financier(s), Size and Terms)	World Bank - US\$ 100 million, sovereign-backed loan with a final maturity of 10 years, including a grace period of 5 years.
Environmental and Social Category	FI
Project Risk (Low/Medium/High)	Medium
Conditions for Effectiveness and Disbursement (If any)	(i) effectiveness of Subsidiary Loan Agreement between the Borrower and PT.SMI (Financial Intermediary).

	(ii) effectiveness of the World Bank loan documents; (iii) adoption of regulations establishing procedures to intercept fiscal transfers to subnational governments.
Key Covenants	The Borrower shall establish satisfactory procedures for the management of the Contingency Fund at the Ministry of Finance.
Policy Assurance	The VP Policy and Strategy confirms an overall assurance that the Bank is in compliance with the policies applicable to the Project

President	Jin Liqun
Vice-President, CIO	D. J. Pandian
Director General, Investment Operations	Supee Teravaninthorn
Manager, Investment Operations	Ke Fang
Project Team Leader	Sylvester Hsu, Senior Investment Operations Specialist
Project Team Members	Baihui Sun, Project Assistant; Frederick Esmundo, Environmental Specialist; Ghufran Shafi, Senior Investment Operations Specialist; Haiyan Wang, Senior Finance Specialist; Ian Nightingale, Procurement Specialist; Philip Daltrop, Senior Legal Consultant; Philip Sayeg, Infrastructure Consultant; Somnath Basu, Senior Social Specialist

## 2. STRATEGIC CONTEXT

### A. Country Context

1. Indonesia, located in Southeast Asia, is the world's largest archipelagic country. With a population of over 250 million, and a GDP per capita of US\$3,524 (2014), Indonesia has emerged over the last decade as a vibrant middle-income economy. Poverty in Indonesia was more than halved from 24 percent in 1999 to 11 percent in 2014, when viewed against the national poverty line<sup>1</sup>. However, despite the substantial reduction in the poverty rate, there are large and growing inter-regional disparities within Indonesia. Indonesia's Gini coefficient index<sup>2</sup> rose from 0.33 in 2005 to 0.40 in 2016.

2. Continued rural-urban migration and population concentration in cities have driven up the country's urbanization rate from 46 percent in 2005 to 54 percent in 2015. There are more than 27 cities with a population greater than 0.5 million, representing a total of 53.2 million or 39% of the country's urban population in 2015.<sup>3</sup> The island of Java, where the capital city Jakarta is located, accounts for about 57 percent of the country's population of 259 million estimated in 2016. Along with continued urbanization is an economic shift from an agriculture-based economy to an urban service-based and manufacturing economy. Of the 20 million jobs created between 2001 and 2011, 18 million were in urban areas, marking a substantial change in the spatial distribution of the country's employments.

3. Indonesia, and its cities in particular, face a backlog of significant infrastructure needs across all sectors and threatens to stifle future growth and prosperity. Inadequate infrastructure is consistently identified by firms as a constraint on their operations and investment in Indonesia.<sup>4</sup> 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. 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.

4. Infrastructure investment played a key role in driving growth and poverty reduction in the 30 years prior to the 1997 Asian financial crisis. Infrastructure investment averaged

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<sup>1</sup> World Bank 2015. *Country Partnership Framework for the Republic of Indonesia*. Report No. 99172. November.

<sup>2</sup> The Gini index measures the gap between the rich and the poor, with 0 representing perfect equality and 1 representing perfect inequality.

<sup>3</sup> [https://en.wikipedia.org/wiki/List\\_of\\_Indonesian\\_cities\\_by\\_population](https://en.wikipedia.org/wiki/List_of_Indonesian_cities_by_population), accessed February 24, 2017.

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



7 percent of GDP from 1995-97, and after falling during the 1997 crisis it has struggled to recover. Total infrastructure investment was around 3-4 percent from over 2011-2013.<sup>5</sup>

5. A fall in 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 declined from 2.3 percent of GDP during 1995-1997 to 0.4 percent from 2008-2011. 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. But this is barely sufficient to keep up with the depreciation of local public assets, let alone meeting the demand for new infrastructure.

## **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 subnational-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.<sup>6</sup> On the revenue side, subnational governments have very limited revenue-raising capacity, collecting about 11 percent of total government revenue in 2015 and receiving majority of their funding from central government transfers. 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. A key gap is therefore the so-called ‘missing middle’ that spans the range of urban infrastructure including water, waste management, drainage, roads and other essential community facilities that requires significant investment due to the infrastructure backlog. By its nature, urban infrastructure is expensive, taking several years to implement, and having a long economic life with benefits accruing over many years. Revenues from user fees, even where applicable, accrue slowly and steadily, and usually require government’s support in getting investment off the ground. At present, no financial institution in Indonesia provides access to long-term financing for subnational public infrastructure

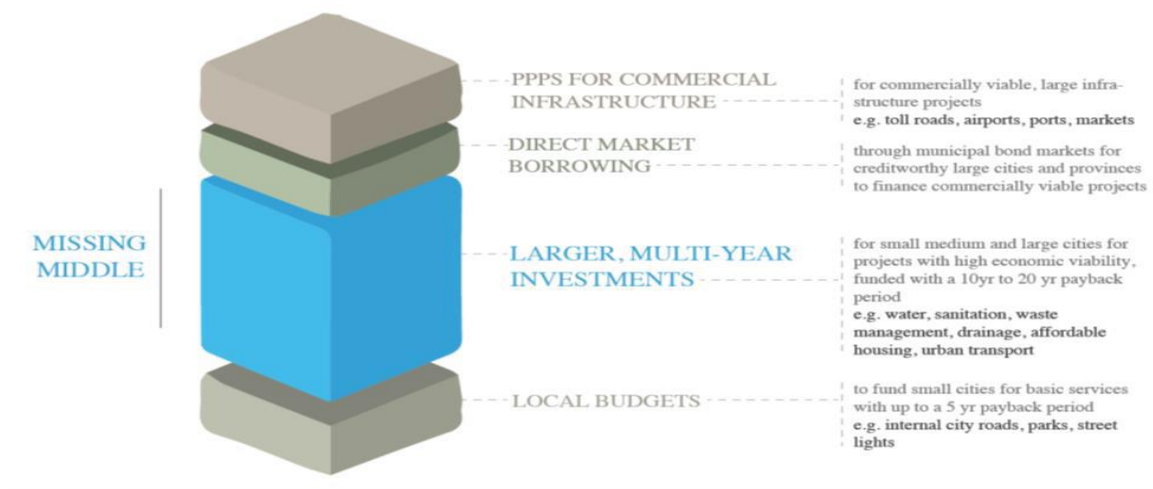
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<sup>5</sup> World Bank, *Indonesia Economic Quarterly – Current challenges, future potential*, June 2011, pp.28

<sup>6</sup> 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.

investment. Addressing this gap is a critical priority for the Government of Indonesia (GoI) (see Figure 1).

**Figure 1: The ‘Missing Middle’ of Infrastructure Finance in Indonesia**



8. Since the 1970s, the GoI has implemented a number of initiatives to facilitate financing for subnational infrastructure investment, with limited success. These initiatives include the establishment of: (i) Rekening Dana Investasi (RDI) which is an Investment Fund Account; (ii) Regional Development Account (RDA); (iii) Subsidiary Loan Agreement (SLA); and (iv) Pusat Investasi Pemerintah (PIP) or Government Investment Center. The RDI, RDA and SLA instruments have experienced significant arrears with limited drawdowns on available finance, while the more recent PIP lending, which is relatively small in scale and scope, has been comparatively more successful.

9. After a number of years efforts made by the government and supported by IFIs, a sound subnational debt framework is now in place in Indonesia<sup>7</sup>. The World Bank estimates that local governments at the 30 largest cities would be able to borrow up to US\$ 3.8 billion under such framework. In parallel to expanding access to finance, addressing the effectiveness and efficiency of local government spending across all sectors is also critical. Subnational governments in Indonesia also lack the technical, institutional or financial capacity to carry out strategic infrastructure investments and keep pace with rapidly expanding demand for local services.

### 3. THE PROJECT

<sup>7</sup> GoI has regulations in place that impose conservative restrictions to regulate subnational borrowing consistent with international standards.

## A. Rationale

10. The Regional Infrastructure Development Fund Project (the Project) 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. More specifically, RPJMN also mentions the use of mechanisms such as a municipal development fund (MDF) for urban infrastructure. The design of the proposed project operation has taken account of those lessons learnt as described below (refer paragraph 24).

11. The Project is well aligned with the Bank's primary mandate, i.e. to promote economic development in Asia through investment in infrastructure and other productive sectors. The Project supports the national government's decentralization program that aims to strengthen the role and autonomy of subnational governments and enhance the subnational debt framework. The Project would support the subnational governments' investment in, and capacity to manage, critical infrastructure that will benefit the urban population through the enhancement of employment, commercial opportunities, connectivity, and goods and services delivery.

12. The Project complements the Indonesia Infrastructure Finance Facility (IIFF) and Indonesia Infrastructure Guarantee Fund (IIGF), both of which aim to support GoI in leveraging private finance into commercially-viable infrastructure projects.

## B. Objective

13. The project objective is to increase access to infrastructure finance at the subnational level through creation of a sustainable financial intermediary, a Regional Infrastructure Development Fund (RIDF), that channels funds from the AIIB, the World Bank, and the government to the subnational governments. The main project beneficiaries are residents in urban areas that will be served by the infrastructure subprojects funded under the project.

14. Achievement of the objective 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. Agreed results indicators are set out in the results framework contained in Annex 1.

## C. Project Description and Components

15. The Project aims to support the structuring and operationalization of the RIDF as a financial intermediary which lends directly to subnational governments. Located within PT Sarana Multi Infrastruktur (Persero) (PT. SMI<sup>8</sup>), the RIDF will increase subnational

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<sup>8</sup> "PT SMI" is an infrastructure financing company which was established on 26 February 2009, as a State Owned Enterprises (SOE) with 100% shares owned by the Government of Indonesia through the Minister of Finance Republic of Indonesia. PT SMI plays active role in facilitating infrastructure financing as well as preparing project and serving advisory for infrastructure projects in Indonesia. PT SMI carries the duty of

governments’ access to finance for basic infrastructure. GoI has indicated its preference for a two-tranche approach for the RIDF, to enable refinement of RIDF’s business model after the initial years of operation. Under Tranche 1, the Bank will provide financing of US\$ 100 million in partnership with the World Bank (WB), who will also finance US\$ 100 million. Together, they will cover half of the initial capital of RIDF. Subsequently, it is anticipated that additional financing will be sought for Tranche 2, so that the aggregated total borrowing from the Bank and WB for RIDF will reach US\$ 500 million. GoI’s request for Tranche 2 can be initiated sooner if the funding for Tranche 1 is utilized earlier than planned.

16. Through the Project, it is expected that subnational governments will be able to address their critical infrastructure needs more effectively and overcome annual funding constraints with the dedicated funding available through the RIDF. The proposed RIDF is a domestic financing solution for urban infrastructure, and is a core element of a national platform for sustainable urbanization, which includes a series of vertical national sector investment and technical assistance programs for, but not limited to: (i) urban transport; (ii) urban water supply and sanitation; (iii) drainage, flood and hazard risk; (iv) solid waste management; and (v) slum upgrading and affordable housing, as illustrated in Figure 2.

**Figure 2: RIDF and a National Platform on Sustainable Urbanization**



17. The Project is structured with two components as described below.

**Component 1: Capital Support for RIDF.**

18. This component will provide up to US\$ 400 million for PT. SMI to operate RIDF as a financial intermediary, which will extend loans directly, at its own credit risk, to creditworthy subnational governments for economically viable infrastructure projects. It is anticipated that RIDF’s initial focus will be on district-level (kota and kabupaten)

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supporting the Government’s infrastructure development agenda for Indonesia through partnerships with private investors and multilateral financial institutions.

governments, before eventually scaling up to more complex regional and inter-regional projects at the provincial level, as its appraisal and financial capacity deepens. As its business grows, the RIDF can also lend directly to local-level state-owned enterprises (e.g. PDAMs (Local level public utility), and Perusahaan Daerah (PD) or Regional level government enterprises).

19. **Eligibility of Subprojects.** The RIDF will fund subprojects<sup>9</sup> that fall within the clear jurisdictional responsibility of the subnational governments under Indonesia's decentralized system. The subprojects must be economically viable and have clear development and poverty reduction impacts. The eligible sectors include water supply, sanitation, sewerage, drainage, solid waste, urban transport including roads, low-income housing, and slum upgrading.

20. Eligibility criteria are set out in Table 1 below.

**Table 1: Eligibility Criteria for RIDF's Financing,  
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
5	Loan amount should not exceed 75% 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).

21. The subprojects under Tranche 1 are expected to be implemented over four years, from April 2017 to December 2020. Further details are provided below under Section 4A on technical aspects.

### **Component 2: RIDF Project Development Facility**

22. A Project Development Facility (PDF) will be established as part of the Project. With the objective of building a pipeline of subproject investments for the RIDF, the PDF will support subnational governments in subproject identification, planning, and preparation. 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

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<sup>9</sup> Individual infrastructure investments funded by the overall RIDF project.

assistance in standardizing designs, and produce a pipeline of quality subprojects for the RIDF.

23. 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.

### **Lessons Learned and Reflected in the Project Design**

24. The design for the Project has benefited from lessons learned from Indonesia's domestic experience with the financing of infrastructure through subnational governments, as well as from international experience with financial intermediary (FI) lending for subnational infrastructure. Below are the key lessons that have been taken into account in the formulation of the Project. More details on these lessons are given in Annex 2.

25. Key lessons from domestic experience include the following:
- (i) 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
  - (ii) Supply-driven lending results in poor performance and weak ownership at the subnational level
  - (iii) Subnational infrastructure financing needs to take full account of the range of possible risks

26. 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 were examined, including those in Colombia (FINDETER), India (TNUDF), Morocco (FEC), the Philippines (LOGOFIND), South Africa (INCA), and Vietnam (HIFU).

- (i) Autonomous and 'arms-length' governance structures are highly correlated with FI financial sustainability and strong performance.
- (ii) On aggregate, FIs do not have a strong track record on achieving significant sector or institutional reforms, or capacity building objectives.

27. In developing the proposed design for the RIDF, a few alternatives were considered and rejected. One such option was to set up the RIDF as a wholesale facility that will lend through commercial banks to the subnational governments. The wholesale model has the advantage of credit risks being shifted away from the FI to the participating commercial

banks. However, the credit provided under the Project could partially replace commercial financing thus would not greatly expanding available financing. Further, if the wholesale credit is subsidized, commercial banks not participating in the scheme will be placed at a commercial disadvantage.

28. A pure credit enhancement model was also considered, where the project fund is used to guarantee all or part of the commercial lending risks, and thus the Project would have offered the potential of drawing in private capital instead of setting up the RIDF. However, a number of factors suggest that this would not be the most effective way forward. Firstly, 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. Secondly, there is limited international experience with pure guarantee facilities which have leveraged on 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.

#### **D. Cost and Financing**

29. The total project cost is estimated to be US\$ 406 million. The financing plan for the Project is outlined below.

**Table 2: Project Cost and Financing**  
(US\$ million)

<b>Project Components</b>	<b>Cost</b>	<b>GoI</b>	<b>WB</b>	<b>AIIB</b>
1. Capital Support for RIDF	400	200	100	100
2. RIDF Project Development Facility	6*	3	3*	-
<b>Total</b>	<b>406</b>	<b>203</b>	<b>103</b>	<b>100</b>

(\*) Includes US\$ 3million in grant from Swiss Secretariat for Economic Affairs (SECO) channeled via WB

30. The initial size of US\$ 400 million for the RIDF is sourced from a combination of equity from GoI, and long-term debt from the Bank and WB. A debt-to-equity ratio of 1:1 has been adopted. Based on the performance of the RIDF, subsequent capital infusions may be at a higher debt to equity ratio.

31. The source of the equity contribution from GoI includes transfer of assets 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, to match their contribution for the Project.

#### **E. Implementation arrangement**

32. PT. SMI is the implementing agency for the RIDF. It will operate the RIDF as its lending business line to subnational governments. As a state-owned enterprise (SOE) that

is solely owned by the GoI through the MoF, PT. SMI is operated under a limited liability structure with the ability to build capital, leverage and blend market financing, and invest in infrastructure projects. RIDF's lending operations will be based on objective appraisal criteria, and backed by an appropriate security structure and all relevant regulations on subnational borrowing, including those issued by MoF and MoHA, as well as technical guidelines issued by line ministries.

### **Lending Policies**

33. RIDF's core lending policies include the following:

- Appraisal of subprojects on the basis of economic 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 5 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.

34. A prudential lending policy with exposure norms defined with respect to borrowers, sectors and projects will ensure that the RIDF's portfolio is well-diversified and not exposed to undue risks. The set of recommended prudential norms for RIDF include:

- Maximum loan value of 90 percent of the total cost of a subproject;
- 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.

### **Cost and Flow of Funds**

35. The Bank's loan proceeds will only be used to finance eligible activities under Component 1, while WB will finance both Component 1 and Component 2. The contribution from GoI will be provided to PT. SMI and subnational governments in loan or equity under Component 1, and in grant under Component 2.

36. The subnational governments will submit a disbursement request to PT. SMI on the RIDF-funded subprojects, which then PT. SMI verifies and forwards to the MoF for processing. The MoF (or PT.SMI on the MoF's behalf) will then submit a disbursement request to the World Bank which would review and clear the disbursement request and notify the Bank to release its portion of the disbursement. MoF publishes an interim financial report quarterly, which will include a 6-month projection of the infrastructure spending needs under the RIDF.

37. Retroactive financing will only be applicable to Component 2 of the Project, and since only World Bank is involved in the funding of Component 2, the Bank will not be providing retroactive financing on this Project.



38. Basic financial sustainability for a financial institution requires pricing that covers its costs and leaves a margin to provide the return expected by investors. RIDF will adopt the same basic principle i.e., 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 at 8.25 percent, it results in a minimum RIDF lending rate of 9 percent under the current conditions. This would be attractive for subnational governments, as available funding for subnational governments in Indonesia ranges from 9.5 percent under the previous PIP, to up to 11 percent for other commercial/institutional funds, though they have a very limited interest in lending to subnational governments. Moreover, commercial loans are usually short term (1 to 5 years) and are only available for commercially attractive projects.

39. 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. With a strong security mechanism, the RIDF loan assets would provide competitive, long-term yields for investors such as pension and insurance funds.

#### **WB Supervision**

40. The WB will be the lead co-financier and will supervise the Project and administer the Bank’s loan on behalf of the Bank, in accordance with the WB’s applicable policies and procedures. A Project Co-lenders’ Agreement, will be signed between the Bank and the WB, in accordance with the existing Co-financing Framework Agreement between the Bank and the WB.

41. The Bank has reviewed: (a) the WB’s Operational Policies (OP) and Bank Procedures (BP) applicable to the Project, specifically, OP/BP 4.01 (Environmental Assessment), 4.04 (Natural Habitats), 4.09 (Pest Management), 4.10 (Indigenous People), 4.11 (Physical Cultural Resources), 4.12 (Involuntary Resettlement), 4.36 (Forests), 4.37 (Safety of Dams), 7.50 (International Waterways), and 7.60 (Disputed Areas); (b) the WB’s Procurement and Consultant Guidelines (2014); and (c) the WB’s sanctions policies and procedures, including the WB’s Anti-Corruption Guidelines. It has found all of them satisfactory for application to the Project, in accordance with the requirements, respectively, of the Bank’s Environmental and Social Policy (ESP) and Environmental and Social Standards (ESSs) (ESS1–Environmental and Social Assessment and Management, and ESS2–Involuntary Resettlement);<sup>10</sup> (b) the requirements of the Bank’s Procurement

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<sup>10</sup> Under the ESP, the Bank may agree to the application, in a project, of the environmental and social policies and procedures of co-financiers (paragraph 10). As a precondition, the Bank must be satisfied that these policies and procedures are consistent with the Bank’s Articles of Agreement and materially consistent with the Bank’s ESP and relevant ESSs, and that appropriate monitoring procedures are in place. In that case, the Bank may rely on the co-financier’s determination of compliance with the co-financier’s policies and procedures.

Policy;<sup>11</sup> and (c) the Bank's Policy on Prohibited Practices.<sup>12</sup> The Bank will accordingly rely on the WB's determination of compliance with the above WB policies and procedures applicable to the Project. Project monitoring and reporting. Financial management will also be carried out in accordance with the WB's requirements. This approach will ensure that one set of policies be applied to the entire Project, and it will also provide a single point of contact for the GoI and therefore facilitate a more efficient and seamless approach to Project implementation.

### **Results Monitoring and Assessment**

42. The Project's Results Framework (Annex 1) provides the basis for measuring progress towards the project's objectives. It includes the project outcome indicators related to increasing access to infrastructure finance at the subnational level, 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.

43. 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 Bank will conduct semi-annual implementation support missions in close coordination with PT. SMI and the World Bank.

### **Conditions to Loan Effectiveness and Covenants**

44. The Bank and the WB will have matching conditions of effectiveness for the two sets of loan documents, which is customary for jointly co-financed projects, relating to the effectiveness of the other co-financier's loan agreement. The following Conditions to Loan Effectiveness and Key Covenants will apply:

- (i) Conditions to Loan Effectiveness:
  - a) The Subsidiary Loan Agreement, acceptable to the Bank, has been executed and

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<sup>11</sup> Under the Procurement Policy, the Bank may agree on a common procedure framework with other co-financiers for a jointly-co-financed Project, if the Bank has determined that the co-financiers' procurement policies are consistent with the Bank's Core Procurement Principles and Procurement Standards (paragraph 5.11.3). In that case, the lead co-financier is normally responsible for overseeing the procurement process, applying its own procurement policy and internal review and clearance procedures, and determining whether the procurement has been conducted in accordance with its own policy. In all cases, the Bank's eligibility requirement will apply, permitting firms and individuals from all countries to offer goods, works and services for a Bank-financed contract.

<sup>12</sup> Under the Bank's Policy on Prohibited Practices, the Bank may agree to the application of the prohibited practices or similar policy and investigations and sanctions processes of certain co-financiers for a Project (paragraph 12.6). As a precondition, the Bank must be satisfied that the co-financier's policy and processes are consistent with the Bank's Articles of Agreement and materially consistent with the Bank's Policy on Prohibited Practices. In that case, the Bank may agree that the co-financier will be responsible for the investigations and sanctions processes and the Bank may agree to give full force and effect to the co-financier's sanctions decisions with respect to investigations arising from the Project.

- delivered on behalf of the GoI and PT. SMI, and has become effective and binding upon such parties in accordance with its terms;
- b) The Co-financing Agreements have been executed and delivered on behalf of the Co-financier and the Borrower, and all conditions precedent to its 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; and
  - c) The procedures to intercept the fiscal transfers to subnational governments have been established by the Borrower.
- (ii) Key Covenants:
- a) No later than September 30, 2017, the Borrower shall establish the procedures, satisfactory to the Bank, for the management of the Contingency Fund at the Ministry of Finance of the Borrower.

## 4. PROJECT ASSESSMENT

### A. Technical

45. **Facility Design.** 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 on long-term infrastructure financing of economically viable subprojects. The RIDF will complement the market for subnational borrowing, which currently lacks options on medium to long-term financing. In the Indonesian context, the key policy challenge is to institutionalize municipal lending through the RIDF, such that as the Indonesian debt market matures, PT. SMI would be able to raise domestic finance based on a rating of the RIDF assets, earnings, and the security mechanisms available therefore reducing the relevant risks. The RIDF would thus enlarge the overall supply of credit for subnational governments and it is expected to attract additional commercial finance in the medium-term.

46. The Project also provides technical and financial capacity building for participating subnational and central government officials, and supports the preparation of sound sub-projects. This would strengthen the enabling environment for municipal infrastructure development and enhance the readiness of subnational governments to borrow for infrastructure, supporting the sustainability of the Project in future.

47. The Project is being designed and appraised under a 'framework approach', where the assessment of project readiness requires that corporate systems, regulations and detailed operating procedures be developed and put in place. At the appraisal stage, the project did not include a definitive list of subproject investments. The project preparation process has identified and pre-screened a list of potential subprojects that will be subject to full appraisal as per the RIDF operating procedures during project implementation.

48. PT. SMI has been assessed to be a financially strong institution. PT. SMI has good capacity overall, and where specific expertise is lacking, such as in safeguards, effort is being taken to actively build up the necessary capacity. Additional specialist staff are also

recruited to enable PT.SMI to implement all the required activities under the RIDF. In addition, a detailed Operations Manual governing all aspects of the Project, and the preparation and implementation of subprojects has been prepared and found satisfactory by the World Bank and the Bank.

49. **Implementation Readiness.** To avoid unnecessary delay in implementation, the project preparation process has identified and pre-screened a list of potential subprojects that will be subject to full appraisal as per RIDF operating procedures during project implementation. The list contains 18 subprojects spread across 10 subnational governments in different parts of the country, with an estimated investment value of US\$ 568 million. Additionally, 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.

## **B. Economic and Financial**

50. **Economic Analysis.** The economic analysis of potential subprojects to be financed by the RIDF can only be undertaken after the establishment of the RIDF and as part of the RIDF's appraisal of such subprojects. Therefore, a framework approach has been developed for economic analysis at the subproject level. The general framework approach to be used for the evaluation of each subproject is based on conventional economic appraisal methodologies. 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 saving 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 consumed. 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.

51. Economic costs and benefits cannot always be reliably quantified and fully valued in monetary terms. Reducing country-wide/regional disparity in infrastructure development is one key end-goal on this Project. Also, the risks and governance issues could pose an unquantifiable factor on the economic benefits of this Project. In the absence of sufficient reliable data to evaluate benefits in monetary terms, an alternate method of evaluating cost-effectiveness may be used. Both the cost-benefit based analysis and cost-effectiveness based analysis will be supported by not only quantitative data, but also with due consideration to the potential qualitative impacts.

52. **Financial Analysis.** The financial analysis of potential subprojects to be financed by RIDF can only be undertaken after the commencement of operation of RIDF and as part of RIDF's appraisal of such subprojects. A financial analysis of the RIDF has been

undertaken based on a set of projected financial statements underpinned by assumptions for the first 10 years of RIDF's operation. 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) was well above 1, indicating a comfortable financial position in meeting the debt service obligations. For the full set of projections, the third drawdown scenario (i.e. debt first and then equity) was adopted.

53. Profits are driven by interest income, which starts off low in the first few years, before growing strongly in line with the growth in the loan portfolio. Key financial ratios for the RIDF— net profit ratio, return on assets, and return on equity – are all healthy throughout the period.

54. 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 the RIDF would be profitable in cases where a net interest margin of at least 0.65 percentage points. Likewise, the RIDF would be profitable so long as the NPL ratio remains below 15 percent.

### C. Fiduciary and Governance

55. **Oversight of PT. SMI's Operation.** The Ministry of Finance (MoF) provides oversight of the PT. SMI's Operation. Under MoF, the DG State Asset Management, which controls assets in the State, provides direct supervision of the daily operation of PT.SMI. The DG Fiscal Balance unit carries out the Intercept Function on the GoI Transfer Mechanism for replenishment of the contingency fund set up under this RIDF project. The DG, Budget Financing Management and Risk Management, and the DG, Treasury are also involved in the operation at PT.SMI.

56. Otoritas Jasa Keuangan (OJK) is a Financial Services Authority set up to monitor and oversee the financial services industry in Indonesia. It has the key mission to protect the interests of consumers and public in the Country. In addition to MoF, OJK will also provide oversight of the operation at PT.SMI.

57. Although it is a SOE, 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.

58. **Intercept Mechanism.** A security structure has been designed for the RIDF that is a post-default 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 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, which will then be used to repay the subproject loan to PT. SMI under the RIDF.

59. **Governing Legislation.** There are three local legislations (PMKs) that will be enacted specifically for the Project. The first PMK is to assign to PT.SMI the task of operating the RIDF and to have MoF provide the guarantee of the loan. This regulation addresses the guarantee scheme, eligibility criteria for borrowing from the RIDF, types of infrastructure to be funded, pricing policy, risk mitigation and monitoring, etc. The second PMK provides the intercept mechanism that would allow MoF to intercept inter-governmental transfers under certain conditions (discussed in the paragraph above). The third PMK specifies the internal procedures, within MoF, on creating and managing the contingency fund for the RIDF. At project appraisal, the first PMK has already been signed by the Minister of Finance and has become effective. The second PMK has been passed on for approval and is included as a condition of loan effectiveness in the loan agreement. The third PMK is still under works within MoF and planned to be finalized within 6 months. The third PMK is considered as a dated covenant in the loan agreement..

60. **Financial Management.** A Financial Management Assessment (FMA) has been conducted by the World Bank 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, in producing timely, relevant and reliable financial information on project activities, and in ensuring the accounting systems for project expenditures and underlying internal controls are adequate to meet fiduciary objectives. It also allows the World Bank and the Bank to monitor compliance with agreed implementation procedures and appraise progress towards these objectives.

61. At this stage, 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 address this issue, PT. SMI and MoF have prepared the Operations Manual on (i) RIDF's organization structure, verification mechanism, reporting/accountability mechanism, IFR preparation and subproject supervision; (ii) types of project expenditures; (iii) arrangements to ensure proper planning and budget allocation; (iv) the funds flow mechanism; (v) disbursement arrangements; (vi) audit arrangements; and (vii) coordination among all stakeholders of the Project. PT. SMI's capacity will continue to be strengthened in many regards to allow it to fulfill its role properly and efficiently on this Project.

62. **Procurement.** Procurement of Goods, Works, Non-Consultant Services and Consultant Services by PT. SMI for its own requirements and those for the subnational governments as beneficiaries under the sub-loans, shall be governed by the Bank's Procurement and Consultant Guidelines and the provisions of the Financing Agreement. As the World Bank is the lead co-financier for the Project, it is proposed that the World Bank's Procurement Guidelines be used, which are also consistent with the Bank's Procurement and Consultant Guidelines.

#### **D. Environmental and Social**

63. The Bank has decided to use the World Bank's Environmental and Social Safeguard Policies (Safeguard Policies) since (i) they are consistent with the Bank's Articles of Agreement and materially consistent with the provisions of the Bank's Environmental and Social Policy and relevant Environmental and Social Standards; and (ii) the monitoring procedures that the WB has put in place to ascertain compliance with its Safeguard Policies are appropriate for the Project.

64. The Project is classified as Category FI, because it involves investment of the Bank's funds through a financial intermediary, PT. SMI, instituted at the national level in Indonesia. The funds will be ultimately used by the subnational governments for infrastructure development. The specific proposal from the subnational governments is being referred to as a subproject. The PT. SMI will screen and categorize subprojects as Category A, B, or C, depending on the social and environmental safeguard implication of the subprojects. The PT.SMI will review, conduct due diligence on, and monitor the environmental and social risks and impacts associated with those subprojects financed under the RIDF, all in a manner consistent with the World Bank's Safeguard Policies.

65. Following a series of stakeholder's consultation, the PT. SMI has prepared an Environmental and Social Management Framework (ESMF) for the RIDF Capital Support (Component 1) and the Project Development Facility (PDF) (Component 2). The ESMF also includes a Resettlement Policy Framework (RPF), Process Framework (PF), and an Indigenous Peoples Planning Framework (IPPF). The ESMF has been disclosed in the World Bank's website as well as the website of PT. SMI. (<http://documents.worldbank.org/curated/en/453751478186707627/Environmental-and-social-management-framework>).

66. Both the PT. SMI subnational governments involved in the Project have demonstrated considerable capability in application and use of the ESMF for programme implementation. However, it has been decided that, at the initial stages, the Bank and World Bank will conduct joint appraisal and review with PT. SMI for the first five high-risk subprojects in the Environmental and Social aspects, prior to subproject approval. If found necessary, this joint appraisal and prior review approach could be extended, till the PT. SMI is fully capable of these functions. In the broader term, the Bank and WB will support the PT. SMI in appraising at least the first few subprojects proposed to RIDF, as well as during the initial two years of the Project.

67. Most subprojects that are being selected for implementation are medium to large scale infrastructure projects, be they new installations or renovations. Implementation of these subprojects will carry various levels of risk, as envisaged in the ESMF. As part of the regular supervision of project safeguards implementation by the Bank, risk mitigation in RIDF's operations will be monitored to ensure that the ESMF is consistently adhered to, and promptly initiate any corrective/ mitigation action as required.

68. For the preparation and implementation of each subproject under the RIDF, the respective subnational government with the assistance of the PT. SMI will be responsible for preparing and executing the plans for the environmental and social safeguards as deemed

appropriate. Given that the success of the project will be measured through its economic performance as well, the project has provisioned a Poverty Impact Analysis study (to be conducted in 2 to 3 project districts).

69. As part of the Bank's mandate, PT. SMI will ensure adequate (a) citizen engagement for all the subprojects through adequate information disclosure, regular impact evaluations, as well as a complaint handling mechanism. Besides, the subprojects will also address issues of (b) gender equity and (c) climate resilience as key cross-cutting imperatives. These are explained in further details below:

70. **Citizen Engagement.** The RIDF's project design includes a number of features to ensure meaningful participation of stakeholders at the local level, so as 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 consultations related to environmental and social safeguards. During project implementation, subproject-specific complaints received and resolved by the subnational governments will be monitored. This Citizen Engagement component has been included as an intermediate indicator in the project's results framework.

71. **Gender Equity.** During implementation, PT. SMI 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 of 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.

72. **Climate Resilience.** During the detailed design stage of the Project, for each subnational proposed project, the physical infrastructure design will incorporate mitigation measures associated with climate change based on the current climate and predicted changes. A simple framework approach has been developed for climate and disaster risk screening at the subproject level. The purpose of climate resilient physical infrastructure design is to reduce property damage, injuries and loss of life during inclement weather conditions. Climate resilience measures will be implemented in conjunction with adaptive capacity (non-physical aspects) to reduce climate impacts to as low as reasonably achievable and practicable. For example, RIDF subprojects involving construction of an underpass will include appropriate design for drainage to prevent flooding during the monsoon season.

## **E. Risks and Mitigation Measures**

73. The risk of the Project is rated Medium, as it has a limited number of clear and identifiable risks; the risk impacts can be identified and mitigatable; few if any of them are



irreversible; and they all can be successfully managed using good practices in an operational setting.

74. The project team assesses the main overall risks to the Project are (i) delay in project implementation; and (ii) an inadequate pipeline. Both risks would affect disbursement and credibility of the RIDF. These risks can be substantially mitigated through adequate technical assistance provided to both the RIDF and the subnational governments. Another major risks are related to safeguards and fiduciary controls on project funds. Adequate procedures and requirements have been included in the Operations Manual, and the existing capacity and systems in PT. SMI have been strengthened during project preparation, and further institutional strengthening will be provided during project implementation.

75. An additional risk to the sustainable operation and maintenance (O&M) of infrastructure to be built under the Project is posed by the currently inadequate sector tariff and inadequate O&M budget at subnational level. The World Bank is working with subnational governments, MOF, and BAPPENAS to strengthen related policies at subnational and national government levels.

## Annex 1: Results Framework and Monitoring

### Indonesia: Regional Infrastructure Development Fund Project

#### 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 of subnational governments	-	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	-	≥100	≥120	≥150	≥150	≥150	Annually		
Average tenor of loans approved by RIDF	<input type="checkbox"/>	Loan tenor in years	-	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"/>	After-tax profits/ Average assets (%)	-	N.A.	≥1%	≥1%	≥1%	≥1%	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"/>	Outstanding principal of past due loans / Outstanding principal of all loans (%)	-	<5%	<5%	<5%	<5%	<5%	Annually		
Proportion of the total loan portfolio concentrated in a single sector	<input type="checkbox"/>	Value of loans in the largest sector / Total value of all loans (%)	-	≤50%	≤45%	≤40%	≤40%	≤40%	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
				Y1	Y2	Y3	Y4	End			
<b><i>Component 1: Capital Support for RIDF</i></b>											
Amount of capital raised	<input type="checkbox"/>	US\$ millions based on loan commitments to subnational governments	-	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 of proposals	-	≥5	≥15	≥25	≥40	≥40	Annually		
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 (%)	-	80%	90%	100%	100%	100%	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.
<b><i>Component 2: RIDF Project Development Facility (PDF)</i></b>											
Number of subnational governments applying for RIDF Project Development Facility services	<input type="checkbox"/>	Number of subnational governments	-	≥5	≥15	≥30	≥40	≥40	Annually	RIDF Annual Report	PT. SMI will calculate and report on these indicators as part of its annual

Intermediate Results Indicators	Core	Unit of Measure	Baseline	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				Y1	Y2	Y3	Y4	End			
Number of projects prepared with assistance from the RIDF Project Development Facility	<input type="checkbox"/>	Number of projects	-	≥5	≥10	≥25	≥35	≥35	Annually		report to RIDF stakeholders.
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 (%)	-	70%	85%	100%	100%	100%	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.

## Annex 2: Detailed Project Description

### Indonesia: Regional Infrastructure Development Fund Project

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 percent<sup>13</sup>.

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,

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<sup>13</sup> 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.

and slum upgrading. Table A2.1 below provides details of eligible sectors and subprojects that are within the framework of RIDF financing.

**Table A2.1: Eligible Sectors and Subprojects**

	<b>Eligible Sectors</b>	<b>Eligible Subprojects</b>
1	Water Supply and Sanitation	<p><u>Water Supply</u></p> <ul style="list-style-type: none"> <li>• 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.</li> <li>• Construction of infrastructure incidental to source augmentation such as construction of jack-wells/bore wells, pumping equipment, etc.</li> <li>• Development of new water treatment plants and capacity augmentation of existing treatment plants including treatment technologies, civil works, etc.</li> <li>• 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.</li> <li>• Installation of water meters at consumer and bulk connections and associated monitoring systems.</li> <li>• Implementation of SCADA and other systems for monitoring and pressure control.</li> <li>• Construction and installation of desalination plants for urban water supply in coastal areas.</li> </ul> <p><u>Sewerage</u></p> <ul style="list-style-type: none"> <li>• Collection network and treatment facility for wastewater.</li> <li>• Pumping stations and machinery.</li> <li>• Regional facilities and system automation.</li> </ul>
2	Environmental Infrastructure	<p><u>Solid Waste Management</u></p> <ul style="list-style-type: none"> <li>• Construction of municipal solid waste processing facilities (sanitary landfill, waste processing plant, incineration unit, etc.).</li> <li>• Construction of processing facility for construction and demolition waste.</li> <li>• Waste recycling projects.</li> <li>• Purchase of vehicles and bins for solid waste collection.</li> <li>• Development of vehicle-tracking and waste disposal monitoring systems.</li> </ul> <p><u>Drainage</u></p> <ul style="list-style-type: none"> <li>• Development of storm water drainage networks.</li> <li>• Rehabilitation of existing drainage networks.</li> <li>• De-silting and/or strengthening of natural drains.</li> </ul>

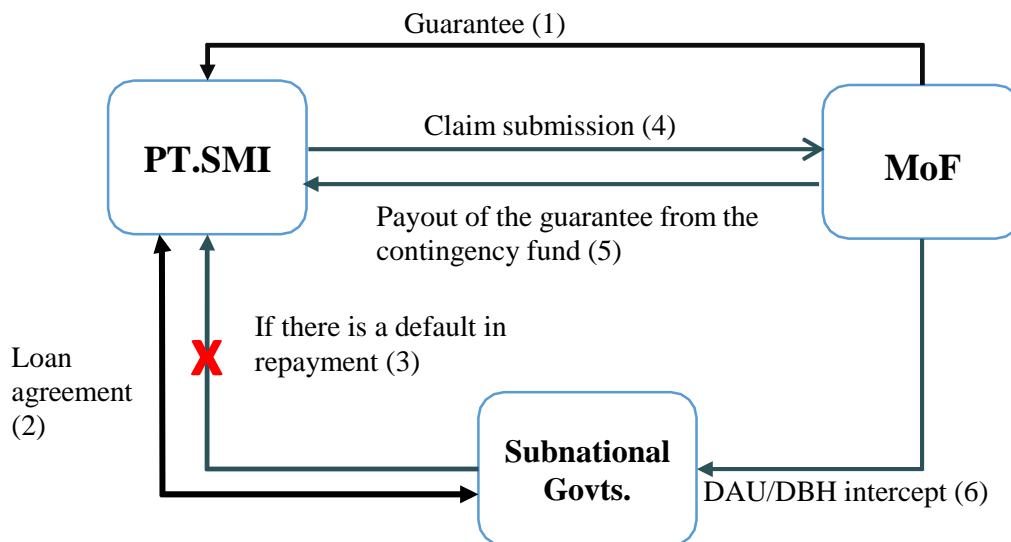
Eligible Sectors		Eligible Subprojects
		<p><u>Energy Efficiency</u></p> <ul style="list-style-type: none"> <li>• Improvement of electric installations and equipment in buildings and public facilities.</li> <li>• Retrofitting buildings and infrastructure for greater energy efficiency.</li> <li>• Improving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

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 (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.

**Figure A2.1: Proposed Security Mechanism for RIDF**



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 governments<sup>14</sup>. The third regulation specifies the internal procedures for creating and managing the contingency fund at MoF.

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.

<sup>14</sup> This second regulation constitutes a revision of PMK No. 47/07/2011 on intercepts of intergovernmental transfers in the case of subnational default.

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 subproject<sup>15</sup>;
- 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.

**Component 2: RIDF Project Development Facility (US\$ 6 million; comprising US\$ 3 million of bilateral grant financing 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;

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<sup>15</sup> 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.

- 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.

### **Lessons Learned and Reflected in the Project Design**

25. 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.

#### Lessons from Domestic Experience

26. **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.

27. **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.

28. **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.

### Lessons from International Experience

29. 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).

30. **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.

31. **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.

32. **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.

33. 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.

## **Annex 3: Economic and Financial Analysis**

### **Indonesia: Regional Infrastructure Development Fund Project**

#### **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.<sup>16,17,18</sup> 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 saving<sup>19</sup> 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

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<sup>16</sup> 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.

<sup>17</sup> 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.

<sup>18</sup> Henderson, V. (2002). Urban primacy, external costs, and quality of life. *Resource and Energy Economics*, 24(1), 95-106.

<sup>19</sup> 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.

incremental water consumed<sup>20</sup>. 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.

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 A3.1: 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

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

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.

<sup>20</sup> Asian Development Bank, (1999),” Guidelines for the Economic Analysis of Water Supply Projects”, ADB, Manila.



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 A3.1: 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 (%)
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% 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 is relatively insensitive to changes in either average costs or average benefit.

**Table A3.2: Sensitivity Analysis**

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

**Box A3.2: 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 activity<sup>21</sup>. Total investment loan agreed and disbursed for this subproject is 42 billion Rupiah or equal to US\$ 3.23 million<sup>22</sup>. 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

<sup>21</sup> An integrated financial and economic analysis of the project is available separately.

<sup>22</sup> Assumption US\$ 1=Rp13,000

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 A3.3: Sensitivity Analysis (US\$)**

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

## 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% based on a cost of borrowing of 8.25%), 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 A3.1 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 A3.1: Impact of Various Drawdown Options on RIDF's Profitability**

	<b>Equity first, then debt</b>	<b>Equity and debt in equal proportions</b>	<b>Debt first, then equity</b>
Average profit after tax (US\$ millions)	27	24	21
Net profit ratio (%)	76	52	29
Return on equity (%)	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 A3.2 for the projected balance sheet.)

**Table A3.2: Projected RIDF Balance Sheet (in US\$ millions)**

	<b>Year</b>									
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
<b>Assets</b>										
Loans to subnational governments	22	138	340	584	784	862	895	828	753	671
Cash	-	-	1	17	88	182	169	246	329	416
<b>Total Assets</b>	<b>22</b>	<b>138</b>	<b>341</b>	<b>602</b>	<b>872</b>	<b>1,044</b>	<b>1,064</b>	<b>1,075</b>	<b>1,082</b>	<b>1,087</b>
<b>Liabilities</b>										
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
<b>Total Liabilities</b>	<b>22</b>	<b>138</b>	<b>341</b>	<b>602</b>	<b>872</b>	<b>1,044</b>	<b>1,064</b>	<b>1,075</b>	<b>1,082</b>	<b>1,087</b>

9. The projected profit and loss statement for RIDF is shown in Table A3.3. 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% of the total interest income during the first 5 years.

**Table A3.3: Projected RIDF Profit and Loss Statement (in US\$ millions)**

	<b>Year</b>									
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
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

	Year									
	1	2	3	4	5	6	7	8	9	10
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
<b>Operating income</b>	<b>0.25</b>	<b>1.52</b>	<b>3.74</b>	<b>15.8</b>	<b>40.8</b>	<b>55.3</b>	<b>61.9</b>	<b>50.1</b>	<b>45.4</b>	<b>39.7</b>
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
<b>Profit before tax</b>	<b>0.01</b>	<b>0.52</b>	<b>1.42</b>	<b>11.7</b>	<b>35.6</b>	<b>49.5</b>	<b>56.0</b>	<b>44.6</b>	<b>40.3</b>	<b>35.2</b>
Income tax	-	0.13	0.36	2.92	8.89	12.4	14.0	11.6	10.1	8.8
<b>Profit after tax</b>	<b>0.01</b>	<b>0.39</b>	<b>1.07</b>	<b>8.75</b>	<b>26.7</b>	<b>37.6</b>	<b>42.0</b>	<b>33.6</b>	<b>30.3</b>	<b>26.4</b>
Dividends paid	-	-	-	-	-	-	-	-	-	-
<b>Retained profit</b>	<b>0.01</b>	<b>0.39</b>	<b>1.07</b>	<b>8.75</b>	<b>26.7</b>	<b>37.2</b>	<b>42.0</b>	<b>33.5</b>	<b>30.3</b>	<b>26.1</b>

10. Based on the above, the projected key financial ratios for RIDF during the first 10 years of its operation are shown in Table A3.4 below. These key ratios – on profitability and the returns on assets and equity – are healthy throughout the period.

**Table A3.4: Projected RIDF Financial Ratios**

	Year									
	1	2	3	4	5	6	7	8	9	10
<b>Net profit ratio (%)</b>	1	3	3	16	37	47	51	44	43	43
<b>Return on assets (%)</b>	0	0	1	1	3	4	4	3	3	2
<b>Return on equity (%)</b>	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 A3.5 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 A3.5: 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%

## Annex 4: Sovereign Credit Fact Sheet Indonesia:

### Regional Infrastructure Development Fund Project

#### A. Recent Economic Development

1. Indonesia is a lower-middle-income country as classified by the World Bank. Indonesia's Gross National Income per Capita rose from \$560 in 2000 to \$3,374 in 2015. According to IMF Article IV 2016 for Indonesia, despite the sharp fall in international oil prices, episodes of capital outflows, and turbulent global financial markets in 2015, the Indonesian economy performed well with a relatively stable growth at 4.7 per cent. This is largely due to sound monetary management and a prudent fiscal stance.

2. In 2016, growth is projected to increase moderately to 4.9 percent supported by domestic demand, which is driven by investment and public sector spending. Inflation has fallen sharply at the end of 2015, and it is expected to remain within the inflation target band (3-5 percent) in 2016. The current account deficit narrowed significantly in 2015 to around 2 percent of GDP on lower imports, but the deficit is projected to increase again in line with higher domestic demand. The fiscal deficit will remain below 3 per cent of GDP, the statutory limit for the general government.

#### B. Economic Indicators

##### Selected Macroeconomic Economic indicators (2014-2018)

Economic Indicators	2014	2015*	2016*	2017*	2018*
National income and prices (change %)					
Real GDP	5.0	4.7	4.9	5.3	5.5
CPI inflation (change %, end of year)	8.4	3.4	4.5	4.4	4.4
Central government operations (% of GDP)					
Central government balance	-2.2	-2.8	-2.8	-2.8	-2.8
Total external debt (% of GDP)	33.1	36.6	36.6	36.0	35.1
Gross external financing requirement (\$bn)	83.8	75.2	82.6	--	--
Nominal gross public debt	24.7	27.5	28.4	29.2	30.0
Public gross financing needs	4.4	4.5	4.6	4.7	4.5
Money and credit					
Broad money (M2, % annual change)	13.5	13.5	14.0	--	--
Net FDI inflows (% of GDP)	1.8	1.4	1.5	--	--
Gross reserves (months imports)	8.0	7.3	6.8	6.6	6.2
Current account balance (% of GDP)	-3.1	-2.0	-2.5	-2.5	-2.6
Exchange rate (Rupiah/\$, end period)	12435	13788	--	--	--

Note: \* denotes projected figures. Source: IMF Country Report No. 16/81, March 2016.

#### C. Economic Outlook and Risks

3. Looking ahead, Indonesia's medium term growth is projected to reach 6 percent by 2020, factoring in strong infrastructure investment and structural reforms that support productivity growth. The main external risks include (i) more volatile global financial conditions with poor market liquidity possibly amplifying volatility in the event of capital outflows, and (ii) a deeper-than-expected slowdown in EM trading partners that could further weaken external demand and commodity prices. The possible domestic risks will be the slow progress in investment-enabling structural reforms and public investment projects, and continued declines in government revenue.

4. On debt outlook, Indonesia's external debt remains at a moderate level of 36.6 percent of GDP in 2015, and is projected to be sustainable over the medium-term. Growth in private external debt is expected to slow as global financial conditions tighten and borrowing costs rise. Public debt remains low while contingent liabilities arising from borrowing by state corporations pose fiscal risks.<sup>23</sup>

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<sup>23</sup> International Monetary Fund (IMF), 2016. Country Report No. 16/81– 2015 Article IV Consultation— Press Release; Staff Report; and Statement by the Executive Director for Indonesia, March, 2016.

## **Annex 5: Coordination with World Bank Indonesia:**

### **Regional Infrastructure Development Fund Project**

1. A joint-appraisal of the Project by the WB/AIIB team was carried out during the 15-19 November, 2016 period and a joint-loan negotiation was carried out on 3rd February 2017. A Project Co-Lenders' Agreement for project implementation will be signed under the provision of the AIIB/WB Co-financing Framework Agreement prior to loan signing. The WB will be the lead financier and provide the following services in accordance with the provisions of the Framework agreement:

- Social and Environmental
- Procurement
- Investigative
- Financial Management
- Disbursement

2. During Project implementation, AIIB staff may conduct joint supervision missions with WB staff. The WB will provide the Bank with copies of all relevant documents, reports, recommendations, no objections and communications (whether external or internal) received or sent by the WB in connection with any of the services provided above.