



1. Project Data

Operation ID P154291	Operation Name Indonesia Energy Sector DPL
Country Indonesia	Practice Area(Lead) Macroeconomics, Trade and Investment

L/C/TF Number(s) IBRD-85570	Closing Date (Original) 30-Jun-2016	Total Financing (USD) 500,000,000.00
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Bank Approval Date 01-Dec-2015	Closing Date (Actual) 30-Jun-2016
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	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	500,000,000.00	0.00
Revised Commitment	500,000,000.00	0.00
Actual	500,000,000.00	0.00

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2. Project Objectives and Policy Areas

a. Objectives

The Development Policy Loan (DPL) aimed to address key energy sector challenges through institutional and policy reforms under four objectives: Reducing the fiscal cost of electricity provision; Improving the investment climate in the energy sector; Removing constraints to renewable energy expansion; and expanding access to modern reliable energy (program document (PD), p. 6).



b. Pillars/Policy Areas

There were four pillars under the program. They were:

Pillar One: Reducing the fiscal cost of electricity provision: This pillar focused on reducing subsidies that were draining the budget and revising tariffs to ensure that they reflected the cost of electricity generation by the State Electricity Company (PLN), the financial condition of which had been weakened by selling electricity below cost. This was to be addressed by (i) phasing out subsidies for larger companies and high electricity consuming residential customers; (ii) indexing electricity tariffs to oil prices, the exchange rate and the rate of inflation for users identified in (i); and, (iii) improving the operational efficiency of the PLN through subjecting it to performance-based regulation, rather than cost plus regulation.

Pillar Two: Improving the investment climate in the energy sector: This pillar was to be achieved by promoting the development of domestic sources of natural gas, the reserves of which were the third largest in the Asia/Pacific region. This would be done by improving the infrastructure for the delivery of gas to domestic users, improving the framework for natural gas contracting, and strengthening the regulatory processes to encourage investment in gas processing, transporting and storing.

Pillar Three: Removing constraints to renewable energy expansion: This pillar focused on reducing environment costs from the use of fossil fuels to generate energy by facilitation of new investments in renewable energy. This was to be achieved by: (i) providing for production bonuses for converting geothermal energy to electricity; and (ii) reviewing existing schemes for promoting market-based mechanisms for developing renewable energy to encourage renewable energy production.

Pillar Four: Expanding access to modern reliable energy: This pillar focused on providing access to reliable electricity for the 39 million people who did not have connections to electricity and to increase the dependability for those who had unreliable connections. This was to be achieved by improving the institutional and pricing structure in rural areas through developing and financing a clear roadmap and action plan to extend and improve electrification.

c. Comments on Program Cost, Financing, and Dates

The first DPL in the amount of USD500 million was approved on December 1, 2015. It became effective on January 4, 2016. The original closing date was June 30, 2016 and the actual closing date was September 9, 2018. The actual amount disbursed was USD500 million. There was to have been a second operation. This was initially postponed and then cancelled due to changing government priorities.

The DPL series was prepared in conjunction with parallel financing from the Asian Development Bank (which provided USD 1 billion), the French Development Agency (which provided USD250 million) and the German Development Bank, which provided USD200 million and Euro200 million) that also provided policy based financing to support government reforms in the energy sector. The development partners continued with their assistance after the World Bank cancelled the second operation.



3. Relevance of Objectives & Design

a. Relevance of Objectives

The objectives of the DPL were based on the energy sector objectives in the Government's National Medium-Term Development Plan for 2015-2019. The objectives were also consistent with the World Bank Country Partnership Framework (CPF) 2016-2020, which stated (p. 26) "Investment in energy will be critical for supplying an expanding economy and for increasing coverage to 60 million Indonesians without reliable access to electricity." The CPF also pointed out that the subsidies in the sector, equivalent to 0.6 percent of GDP were unsustainable. The objectives with respect to renewable energy addressed the need to reduce environmental costs identified in the CPF. The objectives of the DPL were also consistent with those identified in analytical work that suggested reform to the legal and regulatory frameworks for pricing electricity and for developing alternative generation techniques, particularly geothermal power.

The objectives remained relevant at closure, with continuing need for reforms both to access to electricity and to alternative energy production.

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Rating

Substantial

b. Relevance of Design

Reducing the cost of electricity generation in order to increase the fiscal sustainability of the sector was to be based on prior actions that resulted in:

- Phasing out electricity subsidies for larger businesses and consumers;
- Indexing electricity tariffs for larger users to the costs of inputs – the indexing adjustments were later extended to some smaller users based on their income;
- Improving regulation away from a cost-plus basis to a performance basis as well as basing budget support to the PLN on revenue requirements and approved tariffs.

The causal chain between the prior actions and the objectives was plausible and based on extensive analytical work including the Systematic Country Diagnostic, the CPF and Advisory Services and Analytics. The links between these actions and improving the fiscal sustainability of the sector are clear.



To improve the investment climate in the electricity generating sector, the policies adopted through the prior actions were directed at:

- Reducing the uncertainty surrounding gas contract renewal by better management of the process, in order to promote investment in gas production;
- Streamlining the regulatory process for issuing of licenses to independent power producers (IPP) for land use and new projects. The PD (p. 26) indicates that the average time to obtain a license was 600 days

These actions addressed the binding constraints regarding uncertainty that adversely impacted investment by independent power producers in the sector, with a clear causal chain running from actions to the desired outcome. The PD (pp.25-26) describes the obstacles for IPPs in obtaining licenses.

To promote the production of renewable energy, the conditions for this type of investment were improved through the passage of a new Geothermal Law. The law removed geothermal energy production from being defined as a mining activity, which in many cases prohibited geothermal development in conservation areas. It also clarified which agencies had regulatory authority over this type of investment and allocated production bonuses to local communities where the geothermal projects were located. The PD (p. 27) describes “the many institutional, regulatory and tariff constraints” hindering the development of geothermal power, including environmental issues related to development in conservation areas and overlapping ministerial responsibilities.

The causal chain relating the objectives to the prior actions was clear – uncertainty regarding the development of geothermal projects had been identified as a constraint in a number of areas, including which government agencies, laws and regulations applied to the investment.

With regard to improving access to electrification, there were no specific prior actions in the first operation, but a required trigger for the second operation was that the government develop a coordinated national approach in the areas of institutional responsibility, financing and planning, which would then have required specific actions in order to achieve results. Nevertheless, there was an indicator for electrification in the first operation.

Possible improvements to the causal chain might have included specific targets for private sector operators to enter or expand their capacity in supplying electricity to the grid. There could also have been attention to the ownership/operation of the distribution network, which was dominated by PLN (PD p. 51). Best practice competition policy in the electricity sector frequently suggests that generation functions be separated from distribution functions. However, in the light of subsequent developments that led to the cancellation of the second operation, supporting these reforms with prior actions, while highly desirable, might have been a “bridge too far”.

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The second operation

The planned second operation was initially postponed by 24 months as a result of changes in reform priorities following the accession of a new Minister of Energy in 2016 who supported strongly the new priorities. These had changed the focus from market-based reform through increased private sector investment, particularly with respect to renewables, towards faster electrification and “affordability” (ICR p. 5). New policies adopted from 2016/2017 onwards included initially freezing electricity purchase prices and subsequently through basing pricing on the previous year average cost of energy by location. The energy mix favored coal-fired generation at the expense of renewables. Further market intervention by the government included capping the domestic price of coal below international prices and introducing new regulations on the pricing of natural gas, including LNG. Overall, the goal of reducing the fiscal drain from the electricity sector was compromised. Furthermore, the focus on rapid electrification resulted in increased reliance on PLN, at the expense of private sector involvement in electricity production.

The ICR (p. 12) points out that the DPL instrument provided limited leverage in terms of sustaining reform in the context of Indonesia for a number of reasons.

- The amount of the loan was relatively small in proportion to the total budget;
- The ease with which the government can raise debt financing on international markets;
- The sensitive issues associated with introducing more market-based mechanisms into the electricity sector;
- The focus on SOEs rather than on private enterprise;
- The confluence of elections with electricity price increases and the corresponding political sensitivity to the reforms as the elections neared.

The question therefore arises regarding whether the series should have incorporated more political economy considerations into the design or an alternative instrument should have been considered. With hindsight, the conclusion is probably that it should have, but at the time the presence of reform champions within the government made the design of the series, which incorporated sound market based economic principles appear to be a substantial opportunity in spite of the risks. Furthermore,



risk taking under such circumstances should not be discouraged. It is hard to argue that the radical change in policy could have been foreseen.

At appraisal, GDP growth was forecast to average about five percent over the program period (PD p. 14). Fiscal and monetary policy was expected to be prudent with some risks of higher inflation. In the event, the macroeconomic framework was strong. Real GDP growth averaged over five percent annually, primarily as a result of investment and inflation averaged 3.5 per cent per annum. Exports resumed their growth, which resulted in a current account deficit of less than two percent in the 2015-2017 period, although it widened in 2018.

Overall, the causal chains in each of the sub-objectives/pillars that related prior actions to the outcomes were well specified, based on analytical work and accorded with sound international practices in the area of electrification.

Rating

Substantial

4. Achievement of Objectives (Efficacy)

Objective 1

Objective

Reducing the fiscal cost of electricity provision

Rationale

There were three prior actions under this objective that aimed to reduce the cost to the budget of the provision of electricity.

Prior action 1 (PA-1) required the elimination of subsidies for large and medium sized industrial users and eight consumer classes by increasing electricity tariffs. The ICR (p. 6) reports that the subsidies were phased out by the end of 2017. The fall in world fuel prices ameliorated any increases in tariffs resulting from the phasing out of subsidies (ICR p.16). Additionally, subsidy reduction was also supported by the capping of coal prices and the sale price of electricity generated by renewables, but only at the cost of introducing market distortions that discouraged investment in renewable generation.

Tariffs remained frozen thereafter which resulted in a reappearance of subsidies, although the amounts were substantially below what had existed before PA-1 was implemented. This resulted in reduced transfers from the government budget to the PLN. The target value for the reduction in transfers was 49 percent, with the actual amount of 43 percent, although the actual 2013 base on which the reduction was calculated was



found to be 25 percent higher than estimated in the PD, implying that the actual reduction was smaller than initially calculated. The target for this indicator was partially achieved.

The second prior action (PA-2) aimed at linking electricity tariffs to input prices through changes in the regulatory framework. A policy based regulatory framework was introduced to determine electricity tariffs for large users. Tariffs were automatically adjusted based on changes in oil prices, the exchange rate, and inflation. From 2015 onwards these tariff adjustments were to be applied to certain small household users and from 2017, to “non-poor” households.

The third prior action (PA-3) under this objective was the passage of a regulation by the Ministry of Finance to change the regulatory framework from a cost-plus basis to one based on PLN’s performance, with targets to be set based on controllable costs and revenue requirements. While the Ministry of Finance adopted the regulation in 2015, it was not implemented. The results indicator was the implementation of the regulation, which did not occur. From December 2017 onwards, tariff adjustments were frozen as reported in the discussion of PA-1 above.

The second indicator for the achievement of pillar one, which related to PA-2 and PA-3 was that the performance based regulatory framework would result in tariffs and subsidy calculations being based on benchmarks for network losses, thermal plant efficiencies, operation expenses and a productivity improvement adjustment. Because PA-3 was not implemented and tariffs under PA-2 were frozen, the target for this indicator was not achieved.

Triggers for the second operation under the first objective were that the government would devise actions to improve the allocation of electricity subsidies to low income consumers; an improved tariff structure and that performance-based regulation for PLN would be introduced. The freezing of tariff increases in 2017 nullified the first trigger and the second trigger was not implemented.

Rating
Modest

Objective 2

Objective

Objective/Pillar 2: Improving the investment climate in the energy sector

Rationale

There were three prior actions and two results indicators under this objective that aimed to reduce the uncertainty regarding contracting and regulation in the energy sector.

Prior action four (PA-4) required that the Ministry of Energy and Mineral Resources issue a regulation that governed the processes for managing expiring energy production sharing contracts. Uncertainty surrounding



whether contracts would be renewed was reported (ICR p. 7) to be a factor inhibiting investment in the sector, which in turn reduced the supply of gas. The indicator target was that PLN entered into new long-term agreements for gas supply, with a baseline of zero in 2013 that would amount to 125 million cubic feet per day by 2018. The actual amount produced was in excess of 218 million cubic feet per day, which was first achieved in 2016, with the higher production being sustained into 2018.

In order to streamline processes connected with licensing of building rights, land use and location permits (PA-5) as well as coordinating licensing procedures for independent power producers (PA-6), new regulations were issued that reduced licensing times. Processes for licensing independent power producers were delegated to the one stop shop of the Investment Coordinating Board. The results indicator for these PAs was that the time to process a gas independent power producer license would decline from 600 days in 2015 to a target of 300 days by 2016. By July 2018, the time had fallen to 350 days (ICR p. 5) and by the end of 2018 it had fallen to 145 days.

The triggers for the second operation focused on increasing investment in the electricity sector through revising the fiscal terms for production sharing contracts, further revising the regulatory framework to promote accelerated investment in gas processing, storage and transport, and completing a detailed project plan for gas infrastructure development. The fiscal terms trigger for production sharing contracts was met, with the terms being applied to all new contracts and contract extensions. The planning trigger related to infrastructure was partially met. The priorities related to regulatory measures changed away from performance-based regulation so the trigger was not implemented as planned

Rating
Substantial

Objective 3

Objective

Removing constraints to renewable energy provision

Rationale

The PD (p. 8) stated that the government was targeting a higher share of renewable energy in Indonesia's electricity generation. To achieve this, improving the framework for geothermal power development (PA-7) was prioritized through the passage of a new geothermal law and ensuring that local communities in geothermal areas would benefit from payments of a production fee to local governments by geothermal companies (PA-8).

A new geothermal law was passed in 2014. The indicator for the achievement of this objective was that geothermal power projects would be developed according to the provisions of the new law. The target date for this was 2017. In the event 31 geothermal projects were approved totaling an additional 1475-Megawatt capacity compared with the originally installed capacity of 1949 MW. If all investment approval of



IPP projects came to fruition, it would result in 49 percent of geothermal power being produced by the private sector. Payments under the geothermal law were made to local governments covering the 2014-2017 period.

The triggers for the second operation under this objective related to issuing implementing regulations for the Geothermal law and a review of schemes to promote market-based mechanisms to encourage the development of renewable energy. The implementing regulations were adopted and some progress was made in promoting market mechanisms (ICR p.10).

However, market mechanisms in geothermal energy production have not been allowed to work fully. Significant price distortions were introduced in 2017; electricity prices were frozen; domestic coal prices were capped; and renewable energy tariffs were linked to “local average generation”. The latter measure links renewable energy prices to the previous year’s average cost of generation by location. In practice this means that considerable uncertainty surrounds renewable energy prices, particularly since in many cases they have to be negotiated with PLN. The price setting structure favors coal fired generation and discourages investment in geothermal renewable energy production.

Rating
Modest

Objective 4

Objective

Expanding access to modern reliable energy

Rationale

There were no prior actions under this Objective, but a trigger for the second operation was that the government issue a coordinated approach to electrification throughout the country that delineated institutional responsibilities, funding mechanisms and planning. The trigger was partially achieved using PLN as the focal point of a coordinated approach. The first DPL included an indicator, which was an increase in the electrification rate from a baseline of 84 percent in 2014 to a target of 93 percent by 2017. The actual achievement as reported by the Ministry of Energy and Mineral Resources was 98.3 percent by the end of 2018, although the ICR (p. 10) reports that many “last mile” problems remain before the ultimate goal of 100 per cent electrification can be met.

Rating
Substantial



5. Outcome

The objectives were substantially relevant in the light of the need to move away from reliance on coal generated power, the improved efficiency that could be gained from introducing improved regulation and more reliance on market mechanisms into the energy sector, the need for greater private sector involvement in power generation, and the necessity of reducing regulatory uncertainty.

Design was sound, based on market mechanisms that if fully implemented would have contributed to improved productivity in the sector. The question arises with respect to whether the reversals that took place in 2017 and which ultimately resulted in the cancellation of the second operation could have been foreseen. The PD acknowledges (p. 41) the complexity of the political environment and the challenges associated with a reform that reduced “the space for corruption and rent seeking by increasing transparency and reducing discretion”. There is no mention of mitigating measures in the PD, although it is difficult to determine what these might have been apart from reducing the ambition of the reform program. Given that a window of opportunity existed through reformers in government, the risks on balance appear to have been worth taking. Nevertheless, the cancellation of the second operation and the reversal of the reforms detracted from the achievements of the first DPL, which led to a Modest rating.

Under efficacy, the rating of the first objective was modest, given that the targets were not achieved and the freezing of tariffs in 2017 nullified the progress that had been made. Under the second objective, the investment climate in the energy sector was strengthened by the reduction in uncertainty surrounding contracting and the rationalization of regulations and licensing. Under the third objective, a number of disincentives to the production of renewable energy were removed and there was, potentially, a substantial increase in renewable energy production with the target being achieved. Under the fourth objective, the trigger for the second operation was partly achieved and the increase in electrification exceeded the target. With regard to efficacy two objectives were rated modest and two were rated substantial, the overall efficacy rating and the outcome rating is moderately satisfactory.

a. Outcome Rating

Moderately Satisfactory

6. Rationale for Risk to Development Outcome Rating

By the end of the project, there was a reversal of progress achieved and there remains substantial uncertainty regarding the future direction of policy in the electricity sector. Although the ICR (p. 22) reports that the Bank remains engaged through extensive technical assistance and analytical work and is moving forward with investment projects in complementary areas, the risk to achievements under the first DPL being reversed is high



a. Risk to Development Outcome Rating

High

7. Assessment of Bank Performance

a. Quality-at-Entry

The ICRR reports (p. 23) that the Bank mobilized extensive global expertise and experience in electricity sector reform from around the world to carry out diagnostics, technical support, and analysis. There was deep Bank engagement with the government on policy issues related to the energy sector and close coordination with the Asian Development Bank, the German aid agency, and the aid agency of France. The TTL confirmed that the World Bank, with input from development partners, was the main architect of program design and that this has created a platform for future cooperation.

The Bank team worked especially closely with high level reform minded officials within the government who saw the DPL as an opportunity to reform a sector in which productivity was low and which had become a fiscal drain. Furthermore, since the objectives supported by the series were not only relevant but also closely aligned with Government priorities, the rationale for the operations was clear. However, the series of reforms involved some radical changes that conflicted with powerful vested interests within the sector and political considerations overcame technical design issues leading to reform reversal. The design of the two-operation series required that these changes occur within a relatively short period of time and possibly incorporated too broad a menu of reform. A further issue was that although the engagement with the government in planning the first operation drew on extensive in-country experience on the part of the World Bank team, the ICR (p. 22) reports that the team composition changed substantially between the first and second operations and at least partly explains the problems involved in getting the second DPL of the series off the ground.

Quality-at-Entry Rating

Moderately Satisfactory

b. Quality of supervision

In contrast to the preparation of the series and the deep engagement with the government that it involved, the ICR (p. 23) reports that there was no documentation of supervision for the first operation, nor were any ISRs prepared. Furthermore, the World Bank systems contain no detailed records of the circumstances nor negotiations surrounding the cancellation of the second operation in the series, possibly because of the changes in the team outlined above. However, contact was maintained through some TA operations and the platform established to facilitate cooperation with development partners remains in place.

Quality of Supervision Rating

Moderately Unsatisfactory

Overall Bank Performance Rating



Moderately Satisfactory

8. Assessment of Borrower Performance

a. Government Performance

The reforms that underlay the series were initiated by the Government, with a view to increasing the productivity of electricity generation and reducing the fiscal drain on the budget. However, a lack of continuity at the ministerial level (the ICR reports that there were four different Ministers of Energy and Natural Resources over a five year period) led to changes in policy priorities that compromised the objectives of the series, in particular the change that led to a focus on more rapid electrification and a reluctance to adjust tariffs to reflect costs, which was at least a partial reversal back to the situation that existed before the reforms were initiated. The change in priorities to “affordability” implied that there was an increased risk of fiscal drains on the budget. In addition, the changes with respect to controlling geothermal prices and the capping of coal prices and tariff increases subverted the goal of greater alternative energy production.

Government Performance Rating

Moderately Unsatisfactory

b. Implementing Agency Performance

Dividing responsibility for the implementation of the reforms between the Coordinating Ministry for Economic Affairs (CMEA) and the Ministry of Finance, while at the same time having the Ministry of Energy and Mineral Resources (MEMR) responsible for the key technical reforms, hampered coordination. Moreover, the responsibility for technical reforms was shifted to the portfolio of the Coordinating Ministry of Maritime Affairs, which further disrupted program implementation.

Implementing Agency Performance Rating

Moderately Unsatisfactory

Overall Borrower Performance Rating

Moderately Unsatisfactory

9. M&E Design, Implementation, & Utilization

a. M&E Design



The results indicators were well designed to ascertain the achievement of the objectives. They focused on a limited number of key indicators that were relevant in capturing progress of the reforms.

The Coordinating Ministry of Economic Affairs and the Ministry of Energy and Mineral Resources were responsible for collecting data for the results indicators.

b. M&E Implementation

The CMEA and MEMR failed to systematically collect and analyze data for the results indicators. Furthermore, the World Bank did not note this lapse and there were no records, such as implementation status reports or memos to file, noting that results indicator data were not being collected.

c. M&E Utilization

There were no records of the utilization of the M&E framework

M&E Quality Rating

Modest

10. Other Issues

a. Environmental and Social Effects

Environmental risks arose that were related to the development of geothermal projects within forest ecosystems. The Geothermal Law of 2014 reclassified geothermal projects from being mining activities to power development activities. A World Bank TA was provided that gave advice on how adequate the regulations were to address the environmental and social impacts of geothermal projects. There were also social risks that arose from providing land access for geothermal projects in forest areas. These were partly attenuated by providing compensation based on the amount of geothermal energy produced.

b. Fiduciary Compliance

The ICR (p. v) reports that fiduciary risks were rated moderate.

c. Unintended impacts (Positive or Negative)

N/A



d. Other

N/A

11. Ratings

Ratings	ICR	IEG	Reason for Disagreements/Comment
Outcome	Moderately Satisfactory	Moderately Satisfactory	---
Risk to Development Outcome	High	High	---
Bank Performance	Moderately Satisfactory	Moderately Satisfactory	---
Borrower Performance	Moderately Satisfactory	Moderately Unsatisfactory	The change in government priorities that led to the cancellation of the second operation compromised the completion of reforms.
Quality of ICR		High	---

Note

When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.

The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

12. Lessons

The design of DPL series should recognize risks arising for political cycles that could result in changes in priorities as elections approach. In the case of Indonesia, the change in priorities in mid-2016 compromised the successful completion of the series. Under circumstances when political priorities might change, the prospects for sustainability could be increased by briefing Parliamentary committees on the reforms. Alternatively, a less ambitious reform program or one spread out over a longer period of time could increase chances for success

In large middle-income countries that have access to international capital markets, leverage associated with conditionality in a DPL series may not be strong. The size of a DPL relative to the government budget is relatively small and alternative financing is available so that the incentive to reform in order to obtain the loan is not as great as it is in smaller countries. It is therefore incumbent upon DPL teams to ensure to the extent possible that there are clear prospects for completing the reform program. In Indonesia, reform enthusiasm was initially strong but waned as reforms proceeded because of political issues and inter-ministerial rivalries.



When designing programs that require complex implementation, a clear line of responsibility is highly desirable. The complex implementation arrangement in Indonesia, where two ministries were responsible for the overall program, while a third was responsible for technical implementation hampered overall achievements.

When prospective reforms require substantial changes to existing arrangements and responsibilities, which might be strongly opposed by vested interests, a longer time horizon for reform might be desirable. In Indonesia, the program was confronted by opposition to a number of components of the program, particularly with respect to implementing a performance based regulatory system for PLN.

13. Assessment Recommended?

14. Comments on Quality of ICR

This is a high quality ICR, which provides a clear narrative of the evolution of the issues from the design phase through the implementation of the first operation in the series and the factors that led to the cancellation of the second operation. It describes the strengths and weaknesses of the program clearly. The analysis that it contains is sound and well done. At 25 pages, it is a succinct document that could serve as a model for other ICRS

a. Quality of ICR Rating

High