PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA83787

Project Name	Regional Infrastructure Development Fund (P154947)
Region	EAST ASIA AND PACIFIC
Country	Indonesia
Lending Instrument	Investment Project Financing
Project ID	P154947
Borrower(s)	Ministry of Finance, Directorate General of Budget Financing and Risk Management
Implementing Agency	PT Sarana Multi Infrastruktur
Environmental Category	F-Financial Intermediary Assessment
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Estimated Date of Board Approval	30-Nov-2016
Appraisal Review Decision (from Decision Note)	

I. Project Context

Country Context

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

2. Indonesia's transformation is constrained by a large local infrastructure deficit, which threatens to stifle future growth and prosperity in Indonesia. Levels of access to, and the quality of, basic services - such as clean water, sanitation, drainage, housing and transportation - are low and in many cases worsening. In 2015, only about 69 percent of Indonesia's population had access to clean drinking water, and just 30 percent of households in urban areas had access to piped water - a decline of 4 percentage points since 2002. Piped sewerage networks are present in only 12 cities, which in total serve only 2 percent of the urban population. The National Disaster Management Authority (BNPB) lists 22 cities at 'extremely high risk' of urban flooding, highlighting the need for comprehensive planning and investment in floodways, canals, retention basins and protections from sea-level rise. Large numbers of Indonesian households live in informal settlements and substandard housing conditions. The Ministry of Public Works and Housing (MPWH) estimates

that over 38,000 hectares of urban and peri-urban land are classified as slums. Indonesia's Central Statistics Agency (BPS) estimates a housing backlog of 13.5 million units. Urban road networks are unable to cope with the rapid growth in traffic, with an estimated 57 percent of local roads classified as being in bad condition. The modal share of public transport is low and decreasing: it was recently estimated at 7 percent and 5 percent in large and medium-sized cities, respectively.

3. The infrastructure gap in Indonesia also imposes a significant opportunity cost on Indonesia's economic growth and poverty reduction potential. Inadequate infrastructure is consistently identified by firms as a constraint on their operations and investment in Indonesia. If the infrastructure capital stock had grown by 5 percent annually over 2001-2011 instead of the actual rate of 3 percent, it is estimated that real GDP growth would have averaged 5.8 percent, a difference of 0.5 percentage points. If the infrastructure stock had grown by 10 per cent annually, annual real GDP growth would have reached 7 percent. The economic cost of poor sanitation and hygiene alone is estimated to be IDR 56 trillion (USD 6.3 billion) annually .

4. Infrastructure investment in Indonesia has not caught up with pre-Asian financial crisis levels, and lags well behind regional competitors today. Infrastructure played a key role in driving growth and poverty reduction in the 30 years prior to the 1997 Asian financial crisis. After falling off sharply due to the crisis, Indonesia's infrastructure investment has struggled to recover. Total infrastructure investment declined from an average of 7 percent of GDP in 1995-97 to around 3-4 percent from 2011-2013. By comparison, neighboring countries such as Thailand, Vietnam and China registered rates of approximately 7, 8, and 10 percent, respectively. Not surprisingly, Indonesia suffers from some of the poorest infrastructure indicators in the region. In 1996, Indonesia ranked ahead of countries like China and Thailand in the Global Competitiveness Report's index of 'overall infrastructure quality', but by 2002 these countries had surpassed Indonesia.

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

Sectoral and institutional Context

6. Currently available financing instruments in Indonesia are limited and ill-fitting for the nature and scale of the required urban and local-level infrastructure investment. In recent years, Indonesia has developed PPP vehicles for commercially viable infrastructure (e.g. energy generation, distribution and transmission; toll roads; airports and ports), but the market for PPPs is oriented towards large-scale revenue-generating projects. Regulations have been amended recently to enable subnational governments to issue bonds for urban infrastructure, but municipal bonds remain untapped, and only the larger cities or provinces with high fiscal capacity would be in a position to issue such bonds in the absence of a mature municipal bond market. Subnational government budgets (APBD) can only be used to pay for small-scale projects or marginal

improvements in basic services that take less than one year to complete, due to government budgetary rules.

7. Addressing the 'missing middle' for medium- to long-term infrastructure finance is a critical priority for GoI to meet the local infrastructure gap. There are limited sources of project financing for subnational governments seeking to undertake multi-year investments that are economically viable even if not financially viable, such as water supply, sanitation, solid waste, drainage, affordable housing and urban transport projects. These projects generally have significant positive economic benefits, but may not always generate a clear or robust revenue stream.

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

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

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

11. GoI has implemented a number of initiatives to expand access to subnational debt for infrastructure investment, with limited success. The four primary GoI initiatives aimed to expand subnational borrowing include: (i) Rekening Dana Investasi (RDI); (ii) Regional Development Account (RDA); (iii) Subsidiary Loan Agreement (SLA); and (iv) Pusat Investasi Pemerintah (PIP). The RDI, RDA and SLA instruments have experienced significant arrears, whereas more recent PIP lending, while relatively small in scale and scope, has been comparatively more successful.

12. Concurrent to the need to expand access to finance for local infrastructure, greater effort is also required to improve the effectiveness and efficiency of spending at the local level. With the

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

II. Proposed Development Objectives

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

III. Project Description

Component Name

Component 1: Capital Support for RIDF

Comments (optional)

This component will provide up to USD 400 million for PT. SMI to operate RIDF as a financial intermediary lending business line, providing senior debt to subnational governments in Indonesia for economically viable infrastructure projects.

Component Name

Component 2: RIDF Project Development Facility

Comments (optional)

A Project Development Facility (PDF) will be established as part of this project, with the objective of building a subproject pipeline for RIDF by supporting 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.

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IV. Financing *(in USD Million)*

Total Project Cost:	406.00	Total Bank Financing:	200.00
Financing Gap:	0.00		

For Loans/Credits/Others	**Amount**
Borrower	203.00
International Bank for Reconstruction and Development	200.00
SWITZERLAND, Govt. of (Except for FOFEA)	3.00
Total	406.00

V. Implementation

A. Institutional and Implementation Arrangements

13. PT. SMI will be the implementing agency for RIDF, which will operate as PT. SMI's lending business line to subnational governments. As a state-owned enterprise (SOE) that is solely

owned by the GoI through MoF, PT. SMI operates under a limited liability structure with the ability to build capital, leverage and blend market financing, and invest in high quality technical and financial capacity. It has an independent Board and the mandate to make independent appraisal and credit decisions.

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

15. The Directorate General of Budget Financing and Risk Management of MoF, will have the primary responsibility for managing the IBRD loan to GoI for RIDF, as well as for overseeing the security mechanism for RIDF. The Directorate General of Treasury will be responsible for the subsidiary loan agreement (SLA) between MoF and PT. SMI, and for processing and transferring loan funds to PT. SMI. Drawdowns from the IBRD loan will be made on the basis of requests from PT. SMI/RIDF to MoF, and then from MoF to the Bank (see Figure 1 above).

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

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17. A draft Operations Manual (OM) for RIDF has been developed by PT. SMI and MoF. The OM provides detailed operating policies and procedures that will be used for RIDF to process, appraise, provide, and monitor loans to subnational governments; undertake procurement for meeting its own requirements and for also overseeing compliance and monitoring performance of the procurement undertaken by the subnational governments; implement environmental and social safeguards; and for general financial management (planning, budgeting, accounting and financial reporting). The OM also includes the operating policies and procedures of the PDF. The Bank received and reviewed a draft of the OM in June 2016. Since then, the task team has worked closely with PT. SMI to review drafts of the OM, so that a final version of the OM will be available by the time of appraisal completion.

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

B. Results Monitoring and Evaluation

19. The project's Results Framework provides the basis for measuring progress towards the

project's objectives. It includes the PDO-level outcome indicators related to increasing access to infrastructure finance at the subnational level, and the financial performance and sustainability of RIDF, as well as component-specific intermediate indicators, with baselines and targets for each over the life of the project.

20. 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.

C. Sustainability

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

22. In the medium term, as RIDF's business expands, its sustainability will be enhanced when it successfully taps the private capital market such as through bond issuances. It is expected that as revenue streams become available, RIDF could plan the securitization of its assets. From a market perspective, construction risks would have been overcome, and with a strong security mechanism, the RIDF loan assets would provide competitive, long-term yields for investors such as pension and insurance funds. Apart from securitization, subnational government borrowing demands could be pooled together by RIDF (thereby reducing transaction costs and risks) and offered to the debt market based on the security provided.

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VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01	x	
Natural Habitats OP/BP 4.04	x	
Forests OP/BP 4.36	x	
Pest Management OP 4.09	x	
Physical Cultural Resources OP/BP 4.11	x	
Indigenous Peoples OP/BP 4.10	x	
Involuntary Resettlement OP/BP 4.12	x	
Safety of Dams OP/BP 4.37	x	
Projects on International Waterways OP/BP 7.50		x
Projects in Disputed Areas OP/BP 7.60		x

Comments (optional)

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