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APPRAISAL STAGE

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Operation Name	Climate Change Development Policy Loan
Region	EAST ASIA AND PACIFIC
Sector	General agriculture/fisheries/forestry (34%); General public administration (33%); General energy sector (33%)
Project ID	P120313
Borrower(s)	REPUBLIC OF INDONESIA
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Implementing Agency	MINISTRY OF FINANCE
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1. Country and Sector Background

Indonesia is both vulnerable to and contributes to climate change. The GOI's priorities for mitigation are first, in forestry, land use change and peat lands; and second, in fossil fuel use in the power generation, manufacturing and transport sectors. In both cases, high and fast growing emissions can be attributed to upstream policy conditions and governance issues that need to be addressed as part of a shift toward a lower emissions development path. The GOI's adaptation priorities include water management, agricultural production and preparedness to improve disaster response and resilience. The institutional setting for addressing climate change at the national level is a challenge of coordination across multiple sectors. This Climate Change DPL is designed around the key mitigation and adaptation policy areas and specific target actions that the GOI has prioritized in its response to climate change.

Indonesia's commitment to climate change action has been increasingly evident since 2007, when the country hosted the UNFCCC 13th Conference of the Parties in Bali, hosted a high level meeting of Finance Ministers and published its National Action Plan on Climate Change. In 2008, the Government formed the National Council on Climate Change and published its Development Planning Response to Climate Change, a key practical step in mainstreaming climate action into the planning and budgeting process.

Indonesia has made remarkable progress over the last decade in terms of macroeconomic and political stability. Macroeconomic performance since the late 1990's has seen consistent output growth and rapid decline in external imbalances. Increasing tax revenues have contributed to the decline in the fiscal deficit. Increased growth has been grounded on increasing private sector investments, sustained domestic consumption and generally sustainable external surpluses. Under a controlled inflation and rising incomes, Indonesian citizens have enjoyed improving living standards and poverty levels have fallen, although many remain close to the poverty line. Indonesia in 2010 is a highly competitive, decentralized electoral democracy. Governments at national, provincial, district and city level are elected in free and fair contests. A system of checks and balances between legislative, judicial, and executive branches is increasingly in place. Where power was once radically concentrated around the presidency, it is now shared with the legislature, and where power was once concentrated in Jakarta, it is now shared among 500 or so city, district and provincial governments.

Indonesia was less affected by the global economic downturn of 2008-09 than most economies, and by late 2009 the economy had recovered to growth faster than pre-crisis averages. The social impact was also limited with few reports of layoffs, and poverty and unemployment rates continuing to fall, while households' spending power was supported by inflation slowing to decade-lows. Through the crisis public finances remained in good health. Public debt levels continued to decline, ending 2009 just below 30 percent of GDP. International ratings agencies recognized the robustness of Indonesia's economy and strength of its public financial management, upgrading their ratings of Indonesia's sovereign debt in 2009 and early 2010.

Building on a solid foundation of climate change achievements, strong economic performance and consolidated political structure, Indonesia is now proposing to move toward a lower carbon development path, as well as a more resilient and adaptive path that can help to reduce vulnerability and protect the poor in the future.

2. Operation Objectives

The proposed Climate Change DPL series will support GOI's efforts to develop a lower carbon, more climate-resilient growth path by focusing on three main thematic areas: (i) addressing the need to mitigate Indonesia's greenhouse gas emissions; (ii) enhancing adaptation and resiliency efforts in key sectors; and (iii) strengthening the institutions and cross-cutting policy framework needed for a successful climate change response. Mitigation focuses on the key sources of emissions and key targets for reduction, namely, (1) forest loss and peat land conversion and burning (land use change/forestry), and (2) the energy sector, where progress can be made on reducing the incentive to over-use fossil fuels and increasing the incentives to develop renewable energy alternatives and promote energy efficiency. Adaptation focuses on improving the framework for climate resilience in agriculture, water management, coastal and marine resource management, as well as disaster preparedness. Institutional development and cross-sectoral issues relate to the need for better technical understanding, policy coordination, and integration of climate change priorities into the national development planning and budgeting system.

3. Rationale for Bank Involvement

The GOI has requested that the Bank join its existing Climate Change Policy Lending framework in parallel with other development partners. The GOI initiated a Climate Change Program Loan (CC-PL) series in 2008 with financing from Japan (JICA) and Agence Française de Développement (AFD). The Bank's CC-DPL will initially provide parallel financing during this final year of the three year CC-PL series, but with a more selective list of prior actions. The Bank anticipates a four year series of operations, together with existing or new development partners

The rationale for Bank involvement is the GOI's announcement of path-breaking mitigation commitments. At the G20 gathering in September 2009, Indonesian president Yudhoyono announced that Indonesia would reduce GHG emissions by 26 percent by 2020, and make a further reduction of up to 41 percent with international support. This bold action opened the door for more developing countries to make commitments in advance of Copenhagen COP 15. The GOI also joined the G20 pledge to phase out subsidies for fossil fuels. Indonesia is developing a strategic, multi-year policy and investment program for low-carbon growth, as outlined in its Climate Change Sectoral Road Map (December 2009) and its submission to the UNFCCC in fulfillment of the Copenhagen Accord (January 2009).

The Bank recognizes these commitments and builds on the climate policy and financing dialogue between the Government and its development partners. The CC DPL is a strategic opportunity for the GOI to use program/policy lending to support the President's ambitious climate change agenda. The policy actions included in the DPL operation will also contribute to Indonesia's development agenda by improving governance, forest management, efficiency, and competitiveness.

By contributing to the GOI's established program loan process, the World Bank can add value by linking policy reform efforts to broader mosaic of engagement instruments, financing mechanisms, technical assistance and capacity building that the Bank and partners are bringing to bear on Indonesia's development challenges. The Bank can bring its development policy lending experience to the operation to assist the GOI and development partners in streamlining a prioritized program for the future. Finally, the Bank can work with GOI and other partners to link this climate change agenda to the macro economic reform process run by the primary economic development planning and budgeting agencies.

Contribution to CPS. Environment is one of the core areas of engagement of the Indonesia 2009-2012 CPS, which recognizes that the GOI is poised to become a leader and model for developing countries in mitigating and adapting to climate change,. The CPS anticipates facilitating access to new international climate investment instruments; supporting the GOI's REDD initiative and other mitigation actions; and working to reduce Indonesia's vulnerability to natural disasters. It also anticipates policy lending to support progress on key policy reform areas such as those encompassed in this proposed operation.

4. Financing

Loan amount: US$ 200 million single-tranche IBRD loan
The CC DPL is the first in an envisioned programmatic series of four policy loans. The loan would be made available upon loan effectiveness, as all policy actions supported by the loan would have been completed prior to Board presentation.

5. Institutional and Implementation Arrangements

Monitoring the implementation and attainment of the DPL prior actions is done through several mechanisms. These include GOI established Steering Committee and Technical Committee, which are responsible for ensuring the implementation of agreed triggers as well as progress follow-up. In addition regular joint meetings among GOI counterparts and development partners will be held to discuss interim progress in achieving agreed milestones in the reform agenda and future triggers for the DPL series.

GOI has requested that the CC DPL operation follow similar governance and monitoring structures, as have been established under the existing (AFD+JICA) program loan series. The National Development Planning Agency (BAPPENAS) closely coordinates and monitors the implementation of policy actions taken by the responsible institutions. The Steering Committee gives policy direction, provides overall coordination of implementation; approves monitoring results, and coordinate with the donors on confirmation of policy matrix implementation. The Technical Committee monitors schedules and work plans, and reports to and provides recommendations to the Steering Committee. Following this coordination structure, progress on policy actions is reviewed and monitored on a quarterly basis with BAPPENAS and the responsible institutions of GOI, and in close coordination with the co-financing partners. The results of the review and monitoring of progress on policy actions is the basis to determine whether to move on to the next annual operation in the series.

6. Benefits and Risks

Benefits

Mitigation/ Forestry

- Policy harmonization and enabling conditions established for GOI integrated action to reduce degradation and fires on peat land (in high-priority target areas)
- Improved forest and peat land sustainability, land management practices and competitiveness – with institutions and policies positioned to access post-2012 climate regime forest carbon financing mechanisms
- Better governance in the forestry sector through greater transparency, benefit sharing and more equitable access to the environmental and economic services provided by forests.

Mitigation/ Energy

- Increased economic benefits from energy efficiency and increased energy security from investments in renewable domestic energy sources
- Economic and social benefits of reduced fossil fuel emissions in energy and transport sectors (less air pollution, traffic congestion, health impacts)
- Positive steps toward achieving President's emissions mitigation and energy mix goals in accord with GOI energy strategy

Adaptation

- Integration of climate change adaptation and response into preparedness and resiliency plans with disaster prevention and recovery programs and institutions
- Improved basis for response to potential and uncertain changes and impacts in future

Cross-Cutting / Institutional:

- Improved coordination and policy harmonization across a range of institutions critical to the GOI's climate change response.
- Improved policy enabling framework for climate change action and access to climate investment vehicles and post-2012 carbon finance opportunities
- Development partner coordination and parallel financing around a common policy framework and dialogue.

Risks

- Coordination of GOI's climate change national action plans. While coordination across sectors remains a challenge, Indonesia has improved the clarity of its national climate change action plan. These improvements owe much to the Government's response to the President's pledges to reduce emissions. The DPL operation directly harmonizes partner support while focusing analysis, policy advice and monitoring to the steering committee where all institutions are represented, with the expectation that this high level body will provide a forum for cooperation beyond the DPL. Low Risk.
- Commitment to policy reform actions over the medium term. Government commitment to reform is considered to pose low risk, given Indonesia's high profile international commitments, and the integration of Climate Change into the Medium Term Development Plan (RPJM). Low Risk.
- Operation size and visibility. With other partners' parallel financing, climate change program/policy loans represent substantial lending levels. The Bank has focused its efforts on choosing streams of policy actions designed to lead to substantial progress on this critical agenda. Low Risk
- Fiduciary and governance risks. Corruption and governance weaknesses remain impediments to development. The economic DPL series with a key strand focusing on public financial management provides an umbrella for Bank engagements designed to reduce fiduciary risks. Medium Risk.
- Reputational risk. The CC DPL touches a number of "hot button" issues such as deforestation, land management, and energy pricing that draw the attention and criticism of stakeholders. These issues have been discussed with NGOs and other stakeholders through Bank and GOI consultations at various fora. Additional outreach will be undertaken by the GOI and its partners in programmatic lending to explain the nature, contents and benefits of the operation. Medium Risk.
- Forest management is a long term challenge; there is risk that progress will be slow. The risk that business-as-usual will continue is partly mitigated by the potential for access to a system of payments for preserving forest carbon stocks. However REDD itself has risks that cannot be mitigated at the project level as international agreement on a GHG control framework may not arise. Medium to High Risk.
- Energy pricing remains a difficult political challenge and the risk is that progress will be intermittent. The GOI recognizes the importance of progress on this agenda, as the resources from previous subsidy reductions have been important to financing key social programs. More recently the G20 commitment is an important marker, but energy price reform remains a critical political issue. Medium Risk.
- Poverty and social impacts. There is the possibility that low income groups will not benefit from climate finance distribution mechanisms such as REDD. This can be mitigated through a combination of good design and transparency. Similarly, the impact of an increase in energy prices on the poor can be reduced by introducing a compensatory cash transfer program; Indonesia used this approach during recent energy price adjustments. Disclosing and consulting on policies and plans is another measure to allow for public scrutiny and feedback. Medium to High Risk.

Macroeconomic and systemic risks. Indonesia's macroeconomic framework is robust, far more certain than during the financial crisis. Economic performance has been remarkably solid. Fears of balance of payments pressures have proved to be unfounded. Banking sector health remains strong. Incremental upgrades by ratings agencies confirm the soundness of public finances. The floating exchange rate and high foreign exchange reserves provide a buffer against volatility. Low Risk.

7. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

The proposed CC-DPL policy actions for climate change mitigation are likely to have positive poverty and social impacts, for the most part. The poverty and social impacts of policies related to adaptation and disaster preparedness and cross-sectoral and institutional issues are expected to be positive or neutral.

There is some potential for negative social and poverty impacts depending on how a scheme for REDD or improved forest governance is ultimately designed and how forest and peat land conservation are carried out. Land-use patterns and values will be affected; some will gain and others will lose financially from implementation of REDD approaches, or more rigorous environmental standards in land management. Livelihood activities in some areas may be curtailed and possibly move to other areas, creating social dynamics that may have negative consequences. There is a need for caution to ensure that the implementation of REDD schemes does not unduly restrict the livelihoods or deny the rights of indigenous peoples. Any potential negative impacts of change must be evaluated against the business as usual path, which would entail continuing loss of habitat and biodiversity, illegal logging and revenue loss, and marginalization of poor and indigenous communities. For these reasons, the GOI is undertaking a number of actions and consultations through its REDD program, assisted by FCPF, UN REDD and other partners. To assist with the process of preparation and understanding of the need for good design, as well as mitigation of unfavorable social outcomes, the GOI is undertaking a Strategic Environmental and Social Assessment (SESA), as well as a consultation process with CSOs and indigenous peoples as part of REDD preparedness activities.

Some energy sector policy actions, especially changes in prices (due either to higher cost of renewable energy or reduction in energy subsidies), can have a potential adverse effect on the poor. The GOI has in the past combined the reduction of subsidies with a targeted cash transfer program to protect the poor from price changes for a transition period.

Environmental Aspects

The policy actions on forest and peat land management are designed to improve environmental outcomes and reduce emissions. Preserving forest and restoring peat lands will have environmental co-benefits beyond GHG emissions reductions, including improved water resource management, improved biodiversity, and preservation of natural habitats. The CC DPL also proposes policy actions in the area of forest governance and law enforcement to reduce illegal logging and the use of fire in land conversion. Improving the forest governance and management through a Timber Legality Verification System is essential for REDD to function and tackling deforestation.

The REDD framework being developed in Indonesia will ultimately have to come up with mechanisms to avoid or mitigate negative environmental effects. The process of REDD program development in Indonesia is being assisted by a growing set of investments at field and policy level by a host of bilateral development partners and multilateral agencies through the FCPF and UN REDD programs. The global and domestic NGO communities, as well as indigenous communities' representatives, are well aware of these issues and engaged in the process at policy formulation and implementation level. These investments as well as civil society monitoring and advocacy offer the potential to improve the positive and reduce the negative aspects of REDD implementation.

The policy actions on energy policy and promotion of geothermal and other renewable energy sources and energy efficiency have the potential to reduce over-use of fossil fuels, reduce GHG emissions, and produce co-benefits in terms of reduced local air pollution and improved health outcomes. Indonesia's laws and capacity for these kinds of reviews is increasing and the legal basis for enforcement of environmental laws was strengthened in 2009.

8. Contact point

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