I. Introduction and Context

Country Context

1. Despite impressive economic performance and progress on poverty reduction over the past decade, access to public services in Indonesia is still low and their quality remains poor. Indonesia is on course to maintain strong growth performance, currently projected at 6.4 percent for 2012 (relatively stable compared to the 6.5 percent growth in GDP it achieved in 2011). Moreover, Indonesia has transformed this growth into substantial poverty reduction. It has already achieved one of its Millennium Development Goal (MDG) targets by halving the incidence of extreme poverty from 20.6 percent of its population in 1990 to 5.9 percent in 2008. Now, Indonesia is at a critical point where its inadequate infrastructure development – including, low access to improved water supply and sanitation -- is holding back its growth potential and hampering further poverty reduction efforts.

2. The Government of Indonesia has made addressing its infrastructure challenges a strategic
priority. This commitment is demonstrated in the current medium-term development plan (Rencana Pembangunan Jangka Menengah Nasional - RPJMN) for 2010-2014 which sets a range of infrastructure development targets to be achieved by 2014. These targets include improved access to safe water supply and higher quality sanitation. In addition, improving infrastructure is also at the center of the Master Plan for the Acceleration and Expansion of Indonesia's Economic Development: 2011-2025 (MP3EI). Finally, infrastructure spending has also been prioritized in recent budget allocations. In 2011, for example, the budget allocation for capital expenditure was increased by 40 percent relative to the revised 2010 budget. That said, overall levels of investment in infrastructure from all sources currently stand at about 4 percent of GDP and have not returned to the pre-1997/1998 crisis levels of 7-8 percent of GDP.

**Sectoral and Institutional Context**

3. Issues for the sector center on increasing coverage and ensuring that sustainable services are provided. Over the past 4 decades, urban population growth in Indonesia has averaged 4 percent per year, the fastest urban growth rate of any major economy in East and South Asia. Coverage of urban water and sanitation must keep pace with this trend. The sector issues, outlined below, underscore the need to take comprehensive institutional and financial measures to increase the coverage of these basic services and provide them in a sustainable manner.

**Water Issues**

4. Indonesia’s water supply service coverage is low and cannot cope with population growth. More than half of the population still does not have access to safe water and piped water coverage in urban areas has declined from about 36 percent in 2000 to only about 24 percent in 2009. Sector investment has dropped significantly over time, declining from annual spending of US$400 million in the 1990s to only about US$45 million in 2005. Since 2005 there has been only slight increase of investment level, mainly by higher budget allocation from the central government, yet it is still far from the adequate level to meet the demand. The main issues in the sector are:

- **Institutional:** The sector has been largely decentralized and there are more than 400 local water utilities known as Perusahaan Daerah Air Minum (PDAMs). Most of the PDAMs are small and, consequently, have limitations on the institutional capacity to prepare and implement programs of service expansion. This limited institutional capacity has also affected their ability to implement measures that could improve service efficiency (e.g., controlling water losses, which are around 40 percent for most PDAMs). Comprehensive measures to address this problem are not yet in place in most PDAMs.

- **Financial:** More than half of the PDAMs are loss-making, largely due to tariffs which often fail to cover operating costs and often severely limit the PDAMs’ ability to finance investment. PDAMs are expected to be commercially viable and, as a policy, they do not receive grants. Nonetheless, the political economy typically does not allow tariffs to be adjusted upwards to reach cost recovery levels at an adequate pace (average water tariffs are around IDR 1,673 (about US $0.20) per m3). This lack of resources has limited the ability to expand services and has rendered many PDAMs financially non-viable. The financial health of PDAMs must be restored to enable them to provide services in a sustainable manner.

5. Categorization of PDAMs. The government categorizes PDAMs into three groups (“sick”, “less healthy” and “healthy”) on the basis of management, technical, and financial indicators. Overall, the government considers 71 PDAMs “sick”, 128 “less healthy” and 142 “healthy” PDAMs.

6. Challenge of moving PDAMs towards “healthy” status. Preliminary assessments shows that most
PDAM’s immediate requirements to help move them towards “healthy” status are relatively small investments and technical assistance.

Sanitation Issues

7. Indonesia is not on track to achieve the MDG sanitation target. Overall, sanitation coverage (55 percent) is well below the regional average for Southeast Asian countries (67 percent). About 48 percent of the population (urban and rural) in Indonesia does not have access to sanitary toilets and it is estimated that 16 percent of the urban population still defecates openly (2010 Joint Monitoring Program data). Wastewater is treated in only 11 urban areas and sewerage coverage is low, serving only about 2-3 percent of the population. Most of the wastewater from households flows through septic tanks, and wastewater from these tanks is typically discharged to combined sewers that also serve as drains for surface water run-off. The combined sewers are often not covered which creates health and environmental concerns as the water flows through the city. The discharge of untreated wastewater to nearby water bodies also creates serious environmental concerns. Inadequate sanitation is estimated to cost Indonesia about US$6.3 billion annually in incremental health care costs, lost productivity, premature deaths, water resources and fishery losses, declining land values and tourism losses. Grant funds from the central government are available for sanitation (wastewater collection and treatment) but uptake of the grant funds has not been high mainly for the reasons below:

- Institutional: Wastewater services have been decentralized but the local governments (LGs) have not taken a systematic approach to preparing projects and accessing the grant fund (with source of fund from central government and/or from donors). Institutional arrangements differ across LGs. Changes in behavior and a willingness by citizens to pay more are needed to making improvements in sanitation. Adequate institutional capacity should be in place at the local level to promote behavior change and explain the need to charge citizens for improved sanitation services (i.e., through taxes or tariffs).
- Financial: The cost of separated sewerage and wastewater treatment could be very high. While central Government investment grants are available, there are limits on how much funding can be made available for the sector taking into account fiscal considerations (ability of LG to provide budget for complimentary investments) and this will limit the investments. Also, there may be other priorities beyond sanitation that need to be addressed by the LGs.

Government Approach to Addressing the Issues

8. The central Government has set national targets to better meet the needs of the sector. By 2014 the target calls for about 69 percent of the population to have safe access to water (75 percent in urban and 66 percent in rural areas). For urban areas, this implies that 35 million additional people need to have piped water connections. For sanitation, the goal is to eliminate open defecation, increase on-site sanitation systems to 90 percent, and increase off-site systems through the construction of sewers and wastewater treatment plants. To achieve these goals, the Government has taken a number of important steps, including the following:

- Government Regulation (PP) 16/2005: Government regulation on oversight and development of the water supply system, which decentralizes service provision to LGs while the central government retains authority to oversee and grant access to water resources;
- MOF Regulation (PMK) 120/2008: Debt restructuring program for PDAMs. To participate in this debt restructuring program, a PDAM must (i) submit a proposal consisting of a sound business plan for 5 years, (ii) commit to applying a full cost recovery tariff, (iii) implement a “fit
and proper” test selection for its Board of Directors, and (iv) demonstrate commitment of support from LGs and the relevant legislature. The restructuring criteria range from writing off debt with eligible investments to full forgiveness of penalties and interest. There are currently 68 PDAMs with approved debt restructuring program, however this approval is subject to the PDAMs meeting their obligations (including implementation of their business plan).

- Presidential Regulation (PerPres) 29/2009: Interest rate subsidy and partial loan guarantee to provide alternative financing for LGs and PDAMs to borrow from local banks. This scheme is only available to financially healthy PDAMs who have no legacy debt issues, or have completed the debt restructuring program, and thus are able to approach commercial banks. Up to date, there are only three PDAMs have managed to secure the loan from local banks under this scheme.
- PMK 168/2008 and PMK 169/2008: Policy for financing the needs of the sector through on-lending and on-granting mechanisms for LGs. To date, there are about three on-lending arrangements for PDAM investments and more than 30 on-granting arrangements are utilized for poverty targeted investments. Uptake of on-lending has been very slow due to the lengthy approval processes both at the local government and the central government levels. On-lending eligibility also requires a “healthy” status.
- Acceleration of Sanitation Sector Development Program (Program Percepatan Pembangunan Sanitasi Pemukiman – PPSP) in 2009: The five stages of sanitation sector development that need to be implemented by local governments include (i) advocacy, (ii) institutional preparation, (iii) strategic planning development, (iv) memorandum project arrangement (bankable project document), and (v) implementation. Local governments who would like to get any funding for their sanitation sector have to go through these stages. So far uptake from local governments to participate in this program has been relatively high with more than 300 LGs already completed or in the process of completing stage 3 (strategic planning development). However, the progress of moving forward to the next steps has been slow with lack of capacity from LGs in preparing bankable projects.

9. With the existing schemes available only for “healthy” PDAMs, there is still gap of TA and investment needs for the PDAMs with “less healthy” segment. The type of TA and investments needed by this segment is usually not in big amount and may not be feasible to be prepared as stand-alone projects. To address this need, the Government realizes that it needs a wholesale instrument to provide TA and small amounts of investment funding to help these PDAMs improved. The proposed project is aiming to assist the Government in establishing a facility for this purpose, and to provide initial financing.

Relationship to CAS

10. The proposed project is aligned with the Bank’s current Country Partnership Strategy (CPS) for Indonesia 2009-2012. Specifically, the project relates to Pillars 1 and 2, “Improving the Climate for high Quality Investment and Growth” and “Making Service Delivery Responsive to the Poor”. In addition, the project will strengthen the oversight and regulatory role of local and national governments, thus contributing to improved governance and accountability in the water and sanitation sector. Furthermore, a recently-completed Water Supply Investment Roadmap Assistance (WIRA) study -- funded by the Water Partnership Program (WPP) and implemented jointly with the Ministry of Public Works -- which identifies the investment needs and the challenges to meet the MDGs and Government’s targets in the water supply sector recommended development of a water and sanitation facility that would be a mechanism to provide financing for the sector to increase service coverage and improve services. The proposed project responds directly to that recommendation.
11. The new Bank’s CPS for 2013-2015 (which is currently in draft) proposes this project as a support to GOI initiatives to demonstrate operational service delivery mechanisms and arrangements to improve overall water and sanitation sector performance, working with development partners to facilitate a coherent larger combined program of sector development.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

12. The project development objective (PDO) is to increase service coverage and improve water supply and sanitation services in selected LGs and PDAMs. This will be achieved through the establishment of a facility that could be accessed by LGs and PDAMs that are not eligible for accessing existing funding mechanisms. The facility could provide funding for investments as well as technical assistance and capacity building activities to improve the performance of PDAMs and LGs in water and sanitation services delivery.

Key Results (From PCN)

13. The PDO will be measured by a combination of output and outcome indicators such as: (i) additional number of household water connections constructed and (ii) additional number of households with access to improved sanitation services.

III. Preliminary Description

Concept Description

14. There are many PDAMs in the country that may need non-physical technical assistance, improvements to management, commercial and financial systems, and subsequently physical investments to rehabilitate or upgrade existing infrastructure and extend distribution systems to connect more households. Based on assessment and experience from previous projects as well as the ongoing Urban Water supply and Sanitation (UWSSP) project, most of the immediate investments needed by PDAMs and LGs are relatively small (below US$ 10 million). As the facility is developed/designed, the menu of available investments offered by the facility will be specified, including the financing cap of the activities on offer.

15. The proposed project is aimed to be complimentary to existing initiatives, targeting the gaps which are not yet filled by existing sources of finance for water and sanitation investments. It will be targeted to PDAMs and LGs which are not strong or creditworthy enough to borrow from banks (e.g. through the PerPres 29 scheme) but which (i) need support to help them improve their financial and technical performance to achieve commercial creditworthiness, and/or (ii) need some key investments in order to move forwards in meeting their service obligations. The products and criteria of the facility will be designed according to the following principles which are summarized below and shown in the attached Diagram 1:

• The criteria to access the facility and the products offered by the facility will complement existing initiatives.
• PDAMs that are eligible for the PerPres29 scheme are restricted from accessing the facility.
• Technical components and project financing products will be categorized, and the criteria to access them will be designed to incentivize PDAMs to continuously improve their performance and eventually become ‘healthy’.
• Once a PDAM accesses TA support and project financing products in a given category, it will need to make the necessary improvements to the next category level before it is eligible for the
next category of TA and project financing products.

16. The project is comprised of two components: (a) Component A: Water Supply and Sanitation Investment (US$100 million); and (b) Component B: Technical Assistance to Support Sustainable Management of the IWSIF and Service Delivery Improvement (US$20 million).

17. Component A: Water Supply and Sanitation Investment (US$100 million) is expected to finance elements such as the following (indicative list):
   - Water supply: construction of new water treatment plants, rehabilitation and upgrading of existing water treatment plants, expansion and rehabilitation of distribution networks and house connections, implementation of activities to improve operational performance (such as a reduction of Non Revenue Water, energy efficiency, customer database and GIS, etc.), including preparation of the detailed engineering designs and bidding documents.
   - Sanitation: construction of new wastewater treatment facilities, rehabilitation of existing wastewater treatment facilities, expansion and rehabilitation of sewerage systems and house connections, rehabilitation and increased coverage of septage collection and disposal systems, expansion and rehabilitation of drainage systems, as well as preparation of the detailed engineering designs and bidding documents.

18. Component B: Technical Assistance to Support Sustainable Management of the IWSIF and Service Delivery Improvement (US$20 million) is expected to finance the technical assistance required to support the institutional framework needed to sustainably operate and maintain the effective management of the facility and to improve the performance of PDAMs and Local Governments. Activities to be included in this component would include technical support for project implementation, capacity building for the central Government for the operation and management of the IWSIF, capacity building for LGs and PDAMs to improve service delivery, and development or improvement of a web-based National Water and Sanitation Monitoring and Evaluation System that is aimed at increasing public awareness. Details of this system will be agreed upon during project preparation but will include an incentive based mechanism (linked to the investment component) to improve management of these operations.

IV. Safeguard Policies that might apply

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V. Financing (in USD Million)
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