Investment Concept for AIP-Rural (Phase II)

A: Investment Concept Title: Australia-Indonesia Partnership for Rural Economic Development Phase II
Proposed investment start date and timeframe: January 2019 – December 2023
Proposed funding allocation: AUD95 m over five years **Current program fund annual allocation: AUD112 m (2013 – 2018)**
Risk and Value assessment result: Moderate Risk / High Value
Consultation: SED, ACD, MDD
Proposed Design Pathway: DFAT-facilitated design, Post Delegate review
Draft AidWorks Investment number:

B: Problem/Issue definition and rationale for investment (Why)

Agriculture is an important source of jobs, incomes, exports and food security in Indonesia and, as such, represents the best pathway out of poverty for many in Indonesia. 83 per cent of Indonesia's poor live in rural areas, with 65 per cent of poor households in rural areas working in agriculture and more than 60 per cent of household income in rural areas derived from agriculture. The agriculture sector accounts for approximately 35 per cent of overall employment in Indonesia.

Agriculture represents nearly 15 per cent of Indonesia's GDP, despite low average productivity rates compared to other countries in the region. Food remains an important political issue for Indonesia, with food price volatility having a significant impact on the poor, for whom food spending can consume up to a 1/3 of household expenditure.

The Indonesia Aid Investment Plan notes the development program will encourage inclusive economic growth by strengthening the operation of agricultural markets, improving food security, raising agricultural productivity, and helping to boost poor farmers' incomes and employment by addressing constraints such as access to loans. AIP-Rural aligns closely with the Strategy for Australia's Aid Investments in Agriculture, Fisheries and Water through its focus on strengthening markets and innovations to increase productivity and market opportunities for the poor. The program contributes significantly to our aid for trade target (99% of AIP-Rural is counted as aid for trade). The program is a key example of Australia's innovation and private sector engagement strategies in action; AIP-Rural leverages co-investment from the private sector for every intervention and introduces agricultural innovations to farmers to increase quality and productivity.

For the Government of Indonesia, AIP-Rural contributes to the President's Nawacita Plan and the Medium-Term Development Plan (RPJMN 2015-2019), including: accelerating productivity, competitiveness and inclusive development, poverty reduction and inclusive growth, and addressing regional disparity between the east and west by focusing on eastern Indonesia.

The Australia-Indonesia Partnership for Rural Economic Development (AIP-Rural) was planned as a 10 year program in two five year phases. The first phase of AIP-Rural aims to increase the incomes of 300,000 smallholder farm households by 30% through stimulating greater private and public sector investments that create better access for farmers to inputs and markets. It does this by using a market system development approach. It operates in five provinces of Indonesia: East Java, NTB, NTT, Papua and West Papua. It consists of four components:

- PRISMA (AUD77m, Oct 2013-Dec 2018): an agribusiness program which facilitates private sector investment to increase productivity and farmers' incomes in selected commodities.
- ARISA (AUD7m, Jan 2015-Dec 2018): an innovation in agriculture program implemented by CSIRO which develops partnerships between research institutions and the private sector to commercialise agricultural research.
- TIRTA (AUD9.5m, Jul 2015-Dec 2018): a tertiary irrigation program aimed at stimulating private investment to address dry season irrigation needs of farmers.
- SAFIRA (AUD4m, Nov 2015-Dec 2018): a financial inclusion program aimed at increasing farmer access to credit through value chain financing.

A Mid-Term Review (MTR) conducted in September 2016 confirmed that the AIP-Rural approach is working, is achieving strong progress toward its ambitious targets, and is making important contributions to reducing rural poverty and supporting the development of competitive markets in the agricultural sector in eastern Indonesia. Achievements to date include:

- increasing incomes for more than 22,000 households by 35% (a net total of AUD4.3 million)
- of these beneficiaries, 45% are poor households living on less than USD2/day and 32% are women.
- increasing access to innovations for more than 100,000 households
- commencing 55 interventions with 47 private sector partners, who co-invested a total of AUD1.5million
- increasing turnover for 578 small businesses in Indonesia.

The review concluded that PRISMA's plans to scale up successful interventions are appropriate and its monitoring and evaluation system is robust and credible, giving DFAT confidence that the program's poverty reduction targets are on track. In particular, the programs' focus on partnering with the private sector and leveraging private sector funds to achieve development outcomes represents a viable, sustainable and value for money way of working for donors and Government. The MTR recommended DFAT consider a second phase of AIP-Rural with a target of increasing incomes for a further 700,000 smallholder farm households by 30% by 2023.

The three smaller programs – ARISA (managed by CSIRO), TIRTA, and SAFIRA – are at earlier stages and their progress to date has been slower than anticipated. The review recommended that the focus for the remainder of Phase 1 be on proving the viability of the models and assessing possibilities for scale-up, in order to inform DFAT's consideration of including them in any subsequent phase of AIP-Rural.

C: Proposed outcomes and investment options (What)

AIP-Rural Phase II will aim to increase incomes for an additional 700,000 smallholder farm households by 30% (bringing the program total to 1 million households). During the second phase, it is expected that AIP-Rural will be able to contribute more broadly to functioning, competitive agricultural markets and increased productivity in key commodities in Indonesia. Phase II will be submitted to market in a competitive tender.

Phase II will focus on:

- **Continuing a market development approach to increase farmer incomes and improve profitability and competitiveness of the private sector.** The MTR found that the program's Making Markets Work for the Poor approach is cost effective and efficiently and sustainably facilitates private sector firms to deliver innovations that increase the income and resilience of farming households in eastern Indonesia. Phase II will continue to partner with business to introduce agricultural innovations to farmers in a way that increases profits for farmers and businesses alike.

- **Scaling up to reach a total of 1 million smallholder farmers.** The MTR recommended that the second phase consider increased reach and coverage to achieve a new target of an additional 700,000 beneficiaries. Identification of new target provinces in Indonesia will be necessary to achieve this.
- **Systemic change.** Whilst Phase I continues to lay the groundwork through a broad array of carefully targeted partnerships informed by in depth sector analyses, Phase II will be expected to translate this into wider systemic change ie. tangible and widespread impact on agricultural markets and productivity.
- **Consolidation and refinement of the current program.** The MTR recommended DFAT consider simplification and consolidation of the current program to retain focus and allow for easier program management eg. one initiative, one implementation partner, and one contractual arrangement.
- **Increased focus on policy change.** As the program continues to generate good results, it will need to increase its focus on using program evidence to influence positive market development policies in GoI.

The remainder of Phase I will be used to lay the groundwork for expanded scale and systematic change in PRISMA and provide 'proof of concept' for TIRTA, ARISA and SAFIRA, which will be assessed by the program's Strategic Review Panel in June 2017. The design team will then determine whether to continue with these elements in Phase II depending on progress in the next 6-12 months.

A small reduction in the current level of funding beyond 2018-19 is envisaged for the second phase of AIP-Rural, based on consolidation of the four programs.

D: Implementation/delivery approach (How and with whom?)

The MTR confirmed the efficiency and effectiveness of the delivery approach used in AIP-Rural Phase I, particularly as demonstrated by PRISMA, but recommended greater simplification and consolidation of the delivery approach for Phase II. Design of Phase II will consider:

- **one program approach and goal** – focusing the design and related arrangements on the common goal of private sector investment in agriculture to benefit 1 million smallholder farmers in Indonesia. This will require verification of the new target, scoping of new provinces, and consideration of management structures.
- **one initiative** – currently there are three separate contractual arrangements under AIP-Rural, leading to complex management systems and barriers to collaboration between programs. Phase II will be implemented as one initiative, with either: a) three program components (PRISMA, SAFIRA, TIRTA; with ARISA activities to be incorporated under PRISMA) or b) a single expanded program through integration of successful elements from TIRTA, SAFIRA and ARISA into PRISMA.
- **one tender and implementation partner** – Phase II will be competitively tendered and managed as a single program by one managing contractor leading to greater consolidation and value for money.
- **increased focus on scale and systemic change** – as the program moved into the second phase, we expect an increased focus on scale (1 million farmers), but also systemic change to agricultural markets.

As in Phase I, AIP-Rural Phase II will continue to take a Making Markets Work for the Poor delivery approach. This involves selecting sectors and interventions for co-investment with private sector partners based on market opportunities in targeted geographies, income-generating potential for enterprises and farmers, and likelihood of systemic change. Phase II will continue to use the same rigorous monitoring and results measurement systems developed by PRISMA and independently audited by DCED (the Donor Committee for Enterprise Development) to generate performance information.

A scaled up program team similar in structure and distribution to that used in Phase I is likely to be needed, but the design process will review this to ensure value for money. Surabaya has proved an efficient and effective location for the program office, however this will also be reviewed as part of the design process in light of any expanded geography proposed for Phase II.

E: Risk assessment approach (What might go wrong?)

Market systems development programs share development (*i.e.* market and organisational change) and reputational risks with private sector partners that co-invest in interventions and take them to scale with their own resources.

Phase II relies on continued investment by private sector companies providing inputs and services to the agriculture and food security sectors in Indonesia. Phase I experience suggests that even with difficult contextual factors (*e.g.* the El Niño weather event in 2015 and tightening global appetite for investment risk in 2016) AIP-Rural can leverage DFAT investment better than other programs in Indonesia or ASEAN (currently AUD$1.5m leveraged or 26%), and this is expected to improve as the program continues. A range of multinational, national and regional companies have been engaged in Phase I interventions and the appetite for engagement at mid-term was growing. There remains a risk that even if good immediate results are achieved, these might prove insufficient to generate broader impacts on markets and sustainability.

Indonesia has a mixed business environment, especially in eastern Indonesia. The priority given to food security and development in eastern Indonesian suggests that there are opportunities for DFAT to engage with Bappenas and other central agencies (such as the Ministry of Finance) to strengthen the business enabling environment. However, there is also a risk that national policies impact on the success of interventions or the motivation for private sector engagement in AIP-Rural. Lessons from Phase I suggest these contextual risks are manageable because of market diversity and the range of enterprises, business strategies and product types competing for Indonesian and export demand, however Phase II will look more closely at using the evidence generated by the program to positively influence Government of Indonesia policy.

Environmental and social safeguard risks need to be actively managed within Indonesian and Australian policy requirements (*e.g.* Environmental Protection and Biodiversity Conservation Act). AIP-Rural Phase I includes interventions that use agro-chemicals and extend existing irrigation systems using rivers and ground-water resources. Environmental safeguards are therefore a consideration to be addressed in the design process – relying mostly on technical studies conducted during Phase I. Mitigation of this risk factor will be important in design considerations of whether or not to include tertiary irrigation sector in AIP-Rural Phase II (interventions currently implemented under TIRTA). The program will continue to take a proactive approach with regards to gender, disability, child protection, Indigenous rights and animal welfare, in accordance with DFAT's strategies and safeguards.

AIP-Rural Phase I has shown that high calibre human resources are required to deliver results. There is a risk to the delivery of Phase II if appropriate staff cannot be retained or hired in time, as a result of uncertainty about program purpose or duration; economic growth in other parts of the country or economy attracting staff or new candidates away from AIP-Rural and its locations; or delays in DFAT approvals for recruitment of senior positions (e.g. Heads of Portfolio). An expanded geographical focus also involves risks of staff being spread too thinly and potential for problems in new relationships with local government. This will be a key consideration for the tender process.

There remains a reputational risk should the partnerships between AIP-Rural and the private sector be viewed negatively by the media or the public. High risk partnerships are always vetted by DFAT, and a risk mitigation approach taken.

F[1]: Proposed design and quality assurance process (What are the next steps?)

AIP-Rural was planned as a ten-year program in two five-year phases. Given the current phase of AIP-Rural is progressing well, we propose to commence a 6-month 'design update' process in early 2017, focusing on key areas of improvement and scale up to reach new targets. The design will focus on updating key areas identified

[1] Aid Investment managers should refer to the advice on quality assurance options available on the intranet to help ensure the investment will meet DFAT's Investment Design Quality Standards.

by the MTR for simplification or change (eg. governance arrangements), scoping out additional scale up provinces, verifying projections for new targets and consolidating the four programs into one design/tender to provide greater efficiencies and value for money. Aspects such as the overall program approach and logic, M&E systems, and thematic focus, which have been verified as working well in the first phase, are not anticipated to change.

The design update will be a DFAT facilitated design, led by a contracted design specialist and utilising existing in-house expertise in agriculture, market development and M&E (ie. the program's Strategic Review Panel members and the Senior Program Adviser). The team will complement these skills with targeted inputs from gender, disability and other agricultural specialists.

Internal consultation and review will occur with appropriate DFAT personnel including in the South-East Asia Maritime Division, Development Policy Division (EDC, DIS), Multilateral Development and Finance Division (MDD), and Contracting and Aid Management Division (IND, AOP). The draft Investment Design Document (IDD) will be peer reviewed and independently appraised. It will then be revised as appropriate to incorporate final feedback from DFAT and Indonesian stakeholders. The IDD is expected to be ready for approval by the Indonesia Post delegate by September 2017. Once approved, the design will go out to market in an open tender process. AIP-Rural Phase II is expected to mobilise mid/late-2018, ready to commence in January 2019.