



## Concept Peer Review

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1. Australia-Indonesia Infrastructure Grants for Sanitation (sAIG)
2. Water Hibah
3. Sanitation Hibah

5 September 2011

10.00am Jakarta KS MR1

1.00pm Canberra 2R3

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## Acronyms and Translations

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ADB	Asian Development Bank
AIP-CS	Australia-Indonesia Partnership Country Strategy
APBN	<i>Anggaran Pendapatan dan Belanja Negara</i> (National Budget)
AusAID	Australian Agency for International Development
BAPPENAS	National Development Planning Agency
BI	Bank Indonesia
BPKP	Central Agency for Development Audit
CLTS	Community-led Total Sanitation
CSS	City Sanitation Strategies
DAK	Special sector-specific block grant from central to local government
DFA	Direct Funding Agreement
DGFB	Directorate General of Fiscal Balance
DGHS	Directorate General of Human Settlements (Ministry of Public Works)
DPRD	<i>Dewan Perwakilan Rakyat Daerah</i> (Local Legislature)
FY	Fiscal Year
GoA	Government of Australia
Gol	Government of Indonesia
IEG	Infrastructure Enhancement Grant(s)
IndII	Indonesia Infrastructure Initiative
JMP	Joint Monitoring Program
LG	Local Government
MDB	Multilateral Development Banks
MDG	Millennium Development Goal(s)
MoF	Ministry of Finance
MoH	Ministry of Health
MoHA	Ministry of Home Affairs
MPW	Ministry of Public Works
MSMHP	Metropolitan Sanitation Management and Health Project
NPHD	On-granting agreements
NPPH	Naska Perjanjian Penerusah Hibah (On-granting agreement signed between the head of LG and the Minister for Finance.
OBA	Output-Based Aid
PAMSIMAS	Third Water Supply and Sanitation for Low Income Communities
PDAM	<i>Perusahaan Daerah Air Minum</i> (Local government-owned water company)
PDPAL	Wastewater Services Company
PNPM	National Program for Community Empowerment
PPSP	<i>Percepatkan Pembangunan Sanitasi Permukiman</i> (Acceleration of urban sanitation) Policy
RPJMN	<i>Rencana Pembangunan Jangka Menengah Nasional</i> (National Medium Term Development Plan)
sAIIG	Australia Indonesia Infrastructure Grants for Sanitation
USAID	United States of America Aid Agency
WASAP	Water and Sanitation Program
WASPOLA	Water and Sanitation Policy and Action Planning
WB	World Bank
WSI	Water and Sanitation Initiative
WSLIC	Water and Sanitation for Low Income Communities
WSP	Water and Sanitation Program

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## Background

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Water and sanitation has been a priority-sector for AusAID's Indonesia Program for over a decade. Through the Water and Sanitation Initiative (WSI) budget measure, AusAID's support to the sector has evolved from targeted technical assistance through the World Bank's WASPOLA and WSLIC/PAMSIMAS programs, to a more bilaterally-delivered program through the Water and Sanitation Hibah and Indonesia Infrastructure Initiative (IndII). This evolution has placed AusAID as a leading donor in the sector.

With the expected scale-up of the Indonesia program and the announcement of the Water, Sanitation and Hygiene budget measure in the 2011/12 budget, water and sanitation will remain a significant sector of support in AusAID's Indonesia program. This document outlines three initiatives that will carry forward AusAID's scale-up in this sector.

### Concept Notes

This document contains the concept notes for three water and sanitation grants initiatives to be implemented 2011/12 to 2014/15:

1. Australia-Indonesia Infrastructure Grants for Sanitation (sAIIG)
2. Water Hibah
3. Sanitation Hibah

The sAIIG is a new initiative based on the lessons learned from the Sanitation Infrastructure Enhancement Grants (IEGs) activity delivered by IndII in 2010-11 and the Sanitation Hibah. The sAIIG is designed to stimulate local government investment in sanitation infrastructure and to provide incentives for governance reforms in the sanitation sector. The sAIIG will target local governments that do not have existing sewerage and solid waste networks (and therefore, cannot participate in the Sanitation Hibah). Gol has indicated its strong support and desire to implement this type of program in 2012. Peer Review approval of this concept will enable IndII to develop the design for design approval in early October 2011 and implementation in 2012.

The Water and Sanitation Hibahs are extensions of the initiatives delivered in 2010/11. According to AusAID guidelines, extensions require concept-peer review approval to ensure their ongoing relevance. Gol has indicated its strong support for the Hibahs to continue and to be scaled up. This coincides with USAID's contribution of \$10 million to the Water Hibah for implementation in 2011-13. Peer review approval of these concept notes will allow the Indonesia Program to implement the existing Hibah designs in 2012 and to redesign the Water Hibah in early 2012 for expected implementation from 2013. The redesign of the Water Hibah will incorporate new features informed by the lessons of the previous phase and recommendations of the April 2011 Hibah evaluation. Tight Gol-budget timeframes for 2012 prevent a redesigned Water Hibah from being implemented in 2012.

## Australia Indonesia Infrastructure Grants for Sanitation

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*This concept note describes the proposed Australia Indonesia Infrastructure Grants for Sanitation (sAIIG) to be implemented over three years 2012 to 2014. The sAIIG program is designed to stimulate local government (LG) investment in sanitation infrastructure and to provide incentives for governance reforms impacting the sanitation and other sectors. The sAIIG will be delivered to selected LGs using the Government of Indonesia (GoI) on-granting regulations and will be disbursed on an output-based modality upon verification of acceptable sanitation infrastructure outputs. Selection of the LGs and the award of the grants will be made on an assessment of the governance credentials of the LGs. Retention of the grants by LGs will be contingent on their progressive attainment of improved governance milestones through the lifetime of the program.*

## 1. Key development issues and rationale for AusAID involvement

Sanitation service coverage in Indonesia lags significantly behind its ASEAN neighbours. The Joint Monitoring Program, (JMP)<sup>1</sup> reports in a 2010 update that improved sanitation facilities cover 67% of the urban population while some 9% use shared facilities, 8% use unimproved facilities; and an estimated 16% practice open defecation. Municipal services for solid waste sector are equally poor. Less than 50% of the household waste is disposed of in landfills, and very few landfills are operated in accordance with good sanitary disposal practice. In response to this, the GoI has launched its flagship sanitation policy PPSP<sup>2</sup>, a program to accelerate the development of sanitation services in 330 cities. The objectives of PPSP by 2015 are to eliminate open defecation by increased sewerage coverage to 5 percent<sup>3</sup> of urban population in a minimum of 16 cities (includes five cities with new sewer systems); and implementing on-site public sanitation facilities in 226 cities. The PPSP also targets improved solid waste management including recycling in 240 cities, and reduction in flooding of 22,500 ha of land in 100 LGs. The GoI has also enacted the Solid Waste Law 18/2008 which requires mandatory use of sanitary landfills by 2013. In support of the PPSP, IndII implemented the Sanitation Infrastructure Enhancement Grant activity (IEG)<sup>4</sup> during IndII Phase 1. Lessons learned from the sanitation IEGs have been applied to the development of this sanitation AllGs concept note.

Financing for the sanitation sector remains problematic. Despite decentralisation, ministries<sup>5</sup> are receiving the majority share of national funds for sanitation investment. The Ministry of Public Works (MPW) has an approved Medium Term Development Plan (RPJMN) for approximately \$1.7 billion for sanitation over the period 2010 to 2014. The MPW sanitation budget for 2011 is \$300 million. By comparison the GoI special allocation grants (DAK)<sup>6</sup> to LGs for sanitation in 2011 is \$45 million shared amongst 428 LGs with an average allocation of just over \$100,000 for each LG. The implementation of the PPSP over the period 2011 to 2015 is estimated by GoI to cost approximately \$7 billion. Although GoI decentralisation objectives are to increase direct funding to LGs, concerns about the governance of special allocation (DAK) expenditure has deterred significant increases in DAK funding. The grant channel activated by GoI through the on-granting regulations<sup>7</sup> in 2008 offers greater accountability for funds transferred to LGs through binding grant agreements between Ministry of Finance (MoF) and the LGs. This was used effectively by the Water and Sanitation Hibah to channel grants to LGs and to leverage investments by LGs in water and sanitation. To strengthen the accountability for DAK expenditure by LGs, the GoI is also implementing a pilot program<sup>8</sup> in five provinces with the World Bank (WB) which reimburses GoI expenditure for verifiable outputs funded by DAK. The successful demonstration through sAllG of funding channels with proven governance and accountability for fiscal transfers to LGs will assist GoI to channel greater funds to LGs for sanitation, leverage greater commitments from LG and redress the imbalance of funding provisions between the central and LG.

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<sup>1</sup> WHO / UNICEF Joint Monitoring Programme for Water Supply and Sanitation Estimates for the use of Improved Sanitation Facilities Updated March 2010 Indonesia.

<sup>2</sup> Percepatan Pembangunan Sanitasi Permukiman (Acceleration of urban sanitation) policy framework was developed under a Bappenas led Indonesia Sanitation Sector Development Program (ISSDP) program implemented by WB using the Government of Netherlands (GoN) funding.

<sup>3</sup> The present coverage by all sewerage systems is less than 150,000 connections which is equivalent to about 1,750,000 population; this figure being influenced by the 2,000 commercial building connections in PDPAL Jaya with an estimated EP of 500 each.

<sup>4</sup> Sanitation IEGs implemented in 22 local governments during 2010 and 2011 providing a total of \$5.6 million in grants for sanitation infrastructure.

<sup>5</sup> In addition to Ministry of Public Works (MPW) other recipients of national budget funds are, Ministry of Health (MoH), Environment and Ministry of Home Affairs (MoHA).

<sup>6</sup> DAK: Dana alokasi khusus \$2.5 trillion in 2010 and \$2.7 trillion in 2011. The sanitation component of the DAK was \$40 million and \$45 million in 2010 and 2011 respectively

<sup>7</sup> PMK 168 and 169 of 2008 first applied for on-granting of GoI loan funds for the Jakarta MRT have been applied effectively in the Water and Sanitation Hibah and Sanitation IEGs under IndII, and are being applied by GoI for on-granting of national education budget funds. More recently GoI used the same grant channel for a \$150 million WB irrigation loan to finance grants to 110 LGs.

<sup>8</sup> The Local Government and Decentralization Project, loan 7914-ID

### **1.1 How would the proposed grant program / project support government's objectives, policies, and strategies in the sector?**

The proposed sanitation AIIG directly supports GoI PPSP policies and priorities in the sanitation sector which are also aimed at achieving MDG sector targets. While funding has been secured for the roll-out of the planning and preparation components of PPSP, committing funding support for LGs to implement the sanitation infrastructure improvements is more difficult. The key concern to GoI for channelling funds from the national budget (APBN), loans or donor grants to LGs is a demonstrated secure and accountable funding mechanism. The sAIIG program will directly support the sanitation infrastructure investment requirements of PPSP and will demonstrate the effective application of the results based grants as a secure and accountable funding modality for LGs. A proven outcome of the Water and Sanitation Hibah is that direct funding support to LGs can be an effective incentive for mobilising LG budget funds in favour of water and sanitation investment. This will redress the lack of LG funding commitments to sanitation in the short term and will demonstrate the grant channel as an effective mechanism for GoI to support the sanitation sector.

### **1.2 What is the evidence of the partner agency's commitment to and ownership of the relevant policies and strategies?**

The partner agency, Directorate General of Human Settlements (DGHS) of MPW is fully committed to the PPSP policy. The policy was established under the National Water and Environmental Sanitation Working group which is led by Bappenas but has membership from MPW, Ministry of Health (MoH), Ministry of Home Affairs (MoHA), and Ministry of Finance (MoF). The framework of the PPSP identifies a role for each department. While there are drawbacks with an interdepartmental sharing of responsibility it has resulted in greater commitment of funding by GoI in the sanitation sector. MPW has secured a threefold increase in their annual sanitation budget for FY 2011 compared to funding during the previous RPJM.

LGs are committing to the PPSP through the preparation of City Sanitation Strategies (CSS), so far in accordance with the roll-out schedule of the PPSP.

The implementation of the sanitation IEGs demonstrated strong commitment from GoI and LGs with significant excess demand for this modality of support.

In parallel with the increased emphasis of programming and budgeting for sanitation through ministry budgets, the GoI has introduced sanitation as a stand-alone grant under DAK for sanitation in 2009. In FY 2010 the sanitation DAK was \$45 million, up from \$40 million for FY 2009.

### **1.3 How would the proposed grant assistance support the relevant AIP-CS<sup>9</sup> objective(s)?**

The sanitation AIIG supports the Australia-Indonesia Partnership Country Strategy (AIP-CS) Pillar 1 Sustainable growth and economic management through reduced constraints to access sanitation infrastructure and productivity growth. A recent study<sup>10</sup> by the World Bank has shown that Indonesia incurred economic losses of up to 2.3% of GDP due to poor sanitation services. The sAIIG also supports poverty reduction through the focus of communal facilities targeted at densely populated low income households.

This support comes through the direct benefit to poor households with greater access to improved sanitation facilities and services, and through improved governance and sustainability of these services by LGs.

The delivery of this assistance is through the GoI grant funding mechanism which was established in December 2008 and first used by AusAID in delivering the Water and Sanitation Hibah. The grant mechanism was also tested in FY 2010/11 for the delivery of the sanitation IEG program by IndII.

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<sup>9</sup> Australia Indonesia Partnership Country Strategy 2008-13.

<sup>10</sup> Economic Impacts of Sanitation in Indonesia, WSP – World Bank, 2008 identified economic losses of USD 6.3 billion in FY 2006 due to poor sanitation mostly due to health impacts and pollution of water supplies.

The use of this modality strongly supports the broader objectives of the Paris Declaration and the Accra Action Agenda as it impacts on:

- Capacity development of the implementing agencies at GoI and learning from supporting technical assistance;
- Delivery through use of partner country systems;
- Division of labour between participating stakeholders;
- Mutual accountability; and
- Ensuring aid flows are more predictable through Funding Agreements at central level and multi year on-granting agreements at LG level.

The sAIG complements other AusAID programs in the sector including the Sanitation Hibah, the sewerage development programs under IndII Phase 1, WASPOLA, PAMSIMAS, and indirectly supports health improvement objectives under the AIP-CS.

#### **1.4 What are the main lessons from previous studies, technical assistance and other donor support?**

The sanitation IEG pilot activity in 22 LGs during IndII Phase 1 identified fragmentation, questionable sustainability, and poor governance as common problems amongst many of the participating LGs. Investment by LGs in the sector is small<sup>11</sup> compared to other budget expenditure. On average approximately 1% of the LG investment budget goes to sanitation services. If salaries are included the figure drops to 0.4% of the LG budget. This means that the average local government spends about \$100,000<sup>12</sup> on sanitation services each year. Most of this budget allocation is for operational costs and not for investment in new infrastructure. Despite the commitment to the GoI PPSP policy there is significant underinvestment in sanitation infrastructure. Other lessons learned point to poor governance in the procurement of goods and services and inadequate oversight of the sector.

Fragmentation of the sector is symptomatic of poor governance and planning. LGs receive small amounts of funding support from a large number of sources<sup>13</sup>. These funds are allocated to ad-hoc activities rather than consolidated into mainstream infrastructure components. The fragmentation is compounded by the involvement of more than one LG department (Dinas) in delivery of sanitation services. More disturbing is the practice of fragmentation of procurement contracts to conform to direct the purchase requirements of procurement<sup>14</sup> regulations. The overall outcome is a lack of focus and a large number of small scale components mostly linked to the funding source. This lack of consolidation of the sanitation program contributes to poor sustainability in sector development.

The proposed sAIG addresses this problem by stipulating disbursement of the grant only for verified outputs of fixed infrastructure. A condition of the sAIG disbursement will be that LG investments are procured through competitive tenders under the prevailing GoI regulations. This will concentrate the funding of the LG into fewer and larger contracts providing some critical mass in new sanitation service facilities. It will also simplify the oversight of the implementation process which was a problem in the IEGs.

The implementation of the Sanitation Hibah and the IEGs demonstrated strong commitment from LG when support was channelled directly to LG as opposed to GoI support implemented through the technical ministries. The Sanitation Hibah also demonstrated that uptake sanitation services by

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<sup>11</sup> Estimates by IndII of all LG expenditure on sanitation based on extrapolation from the budgets of the 22 LGs. Of that a smaller fraction is applied to infrastructure.

<sup>12</sup> Excluding DAK

<sup>13</sup> In addition to the DAK and DBH the LG receive funds from central government via **DPDF&PPD** (Dana Penguatan Desentralisasi Fiskal dan Percepatan Pembangunan Daerah, based on PMK 118/2010 - fund for strengthening fiscal decentralization and acceleration of regional development); **DPIPD** (Dana Penguatan Infrastruktur Dan Prasarana Daerah (based on PMK 113/2010 - Fund for strengthening regional infrastructure and services); **DPPID** (Dana Percepatan Pembangunan Infrastruktur Daerah - fund for acceleration of regional infrastructure development).

<sup>14</sup> Presidential regulation 54 of 2010 which allows contracts of less than IDR 50 million to be procured directly without competitive tendering.



the community requires more socialisation of the benefits than for other social infrastructure services such as water supply and solid waste management.

### **1.5 What are other development partners doing and how does the proposed AusAID assistance fit with this?**

There are two relevant streams of assistance from donors: (i) assistance to the sanitation sector; and, (ii) decentralisation and governance.

The World Bank – WSP is focusing on implementation of the AusAID-funded WASPOLA facility, and the delivery of sanitation capacity improvements at LG and subdistrict/village level through implementation of the Community-Led Total Sanitation (CLTS). WSP has secured \$3 million from the Gates foundation in 2008-10 and is applying a further \$1.7 million from the Gates Foundation for refinement of the CLTS capacity building at LG during 2011 and 2012. These policy and capacity improvements are complemented through the availability of funds from the sAIG to implement LG programs.

The World Bank is implementing the \$22.5 million AusAID-funded PAMSIMAS component under WSI which includes community based sanitation for approximately 500 villages. The AusAID-funded component is part of the International Development Association (IDA)-funded PAMSIMAS program covering 5,000 villages and peri-urban areas implemented as a community based water and sanitation program through DGHS.

The ADB is financing the Metropolitan Sanitation Management and Health Project (MSMHP) in Medan and Yogyakarta which will finance downstream sewerage improvements. These will require expansion of upstream tertiary and domestic sanitation infrastructure to feed the downstream expansion. The sAIG will support these upstream developments.

The ADB is planning to finance future sewerage investments in five cities which will also require investment of upstream infrastructure by LGs. This again will be supported through the sAIG.

The ADB has also recently signed a loan for \$100 million to support community-based sanitation improvements to strengthen the demand upstream of on-going and proposed sewerage investments.

The Government of the Netherlands is supporting Gol with the Urban Sanitation Development Program which provides €10 million for the development of PPSP pipeline projects including CSS. The sAIG will provide support to LG to implement the pipeline programs.

The World Bank is supporting the strengthening of DAK accountability through a \$220 million loan which reimburses Gol for good governance and accountability of DAK disbursements. The disbursements from the WB loan are based on LG achieving prescribed outputs of infrastructure (roads, irrigation, water, and sanitation). The World Bank DAK project uses the Gol State Finance and Development Supervisory Board (BPKP) to provide the oversight verification. The menu of acceptable options for sanitation DAK reimbursement is similar to that proposed for the sAIG except that the sAIG will have greater detail including the level of the grant for each component.

### **1.6 What Additionality will sanitation AIG funding bring?**

The sAIG will focus on support for physical infrastructure. This will shift the balance of spending by LGs from discretionary recurrent expenditure to spending on fixed infrastructure for services. The formula for the sAIG will be output-based<sup>15</sup> and will provide an average 55% of the cost of physical works for new infrastructure. The LG will need to pre-finance the full cost of implementation for a net contribution of 45% after the grant is received. By comparison the Gol DAK funding requires a

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<sup>15</sup> Output-based grants are one form of Results Based financing in which the payment of grants is contingent on the recipient achieving an agreed outcome. In the sAIG, the outcome will be the construction of sanitation infrastructure to an acceptable standard from an approved menu of options for sanitation and solid waste facilities.

10% contribution from LG. The proposed 55% sAIG will leverage LG financing for physical infrastructure to significantly higher levels than LGs are providing now. Pre-financing will also stimulate some LGs to mobilise otherwise dormant financial reserves deposited in Bank Indonesia certificates of deposit. The LGs will continue to finance their obligatory recurring costs. The net result will be an overall increase of the LG sanitation budget with a significant increase on fixed infrastructure investment and a reduction of discretionary recurrent spending. The LGs will be encouraged to consolidate their various discretionary funding sources to invest in sAIG qualifying infrastructure. Over the course of the program this will result in observable improvements to service delivery by LGs.

The implementation of the program over three consecutive budget years will allow the sAIG to include tests on LG achievement of benchmark milestones on governance as well as physical investments. The governance benchmarks will be linked to annual reviews while the physical targets will be more flexible. Failure to achieve governance targets will be grounds for review and ultimately suspension of the grant.

### **1.7 What is the evidence of the partner agency's (i) commitment to implementing reforms and improving governance (ii) preparedness to work on project preparation?**

The partner agency, DGHS actively participated in sanitation IEG program from design to implementation. During implementation the DGHS witnessed first hand the difficulties of supporting sanitation sector development and governance at LG. The partner agency endorses the intent to simplify and rationalise the design of the AIG to an output-based format. Both DGHS and the Directorate General of Fiscal Balance (DGFB) have indicated their readiness to participate in the design of the sAIG. DGHS has established a team to support IndII during the design progress. DGHS also provided budget funds for an operational Central Project Management Unit (CPMU) to oversee the implementation of the sanitation IEGs and would do so again for the sAIG.

Moreover the DGHS and the DJPK have demonstrated during the implementation of the Water and Sanitation Hibah and the sanitation IEGs that they are willing to enforce governance issues arising from the LG implementation of the grant programs.

A more critical issue will be the willingness of LGs to adopt governance criteria for continued access to the grants. Evidence from the Hibah and IEG program shows that heads of LG are willing to take a tough line on services that directly impact the community especially where the program is associated with a high profile and has a visible impact to constituents. The litmus test for the sAIG will be the level of buy-in by LGs to the governance criteria and their ultimate performance in meeting the criteria.

## **2 Proposed project development objective(s)**

The project development objectives are:

- (1) Increase LG investment on sanitation infrastructure towards meeting the Gol and MDG sanitation service targets by providing up to \$50 million in output-based grants to 40 LGs that first invest \$95 million in sanitation infrastructure during the three year period 2012 to 2014.
- (2) Improve governance of the sanitation sector at LG by increasing the accountability of LGs to adhere to an agreed sanitation investment program and to incremental improvements in governance of the sanitation sector.

*What will success look like at the end of the program?* – A successful outcome will be one in which the participating LGs increase their overall sanitation expenditure significantly above non-participating LGs, and more of that increase will be directed to fixed infrastructure investments resulting in increased beneficiaries of sanitation services. The increases in sanitation services will be accompanied by increased transparency and governance in the delivery of the services.

### 3 Preliminary Activity Description

The sAIG will provide grants to LGs defined in an ‘on-granting<sup>16</sup> agreement’ and delivered through an output-based modality. The selection of the participating LGs and the size of the grants awarded to each LG will be based on criteria that measure the performance and commitment of the LG to develop sanitation services. Evidence of good governance at LG, or the absence of negative audit findings by BPK could be used as a factor in selection. Willingness of LG to commit to progressive governance milestones will be a precondition for acceptance. The menu of infrastructure facilities that will be approved for a grant will be restricted, and will be defined by agreed specification and unit cost rates. This menu already exists and needs only to be refined for application in the sAIG. A similar menu has been applied by the WB DAK reimbursement project. The grants for each type of infrastructure component will be predetermined on a scale of approximately 55% of the total cost of construction. The local government will sign an on-granting agreement and implement the works in accordance with standard Technical Ministry specifications and technical guidelines. An independent verification consultant will review the completed works in the field, and the achievement of governance milestones, and will make recommendations for payment of the grant or identify shortfalls in quality or quantity of facilities constructed. Failure to meet governance criteria will trigger a review of the grant agreement with the ultimate penalty being cancellation of the grant. Failure to meet physical quality or quantity targets will result in a requirement to ‘make-good’ or non disbursement for the non qualifying component.

The DGHS will be the principal partner agency and responsible for execution of the program. AusAID/IndII will cooperate with DGHS, DJPK and Bappenas to design the program. DGHS in consultation with AusAID/IndII will have primary responsibility for the selection of the LGs and the allocation of the grants. The DGHS will propose the selected LGs and grants to DJPK for award of the on-granting agreements. AusAID/IndII will work with DGHS and DJPK to prepare the Direct Funding Agreement, the Implementation Manual, and the content of the on-granting agreements. The DGHS will issue the Implementation Manual by a decree of the Director General. The DGHS will establish a Program Management Unit and will be responsible for the technical oversight of the sAIG. IndII will engage baseline and verification consultants to support the DGHS with implementation oversight. DGHS will be responsible for reviewing applications for payment by LGs and recommending grant disbursements, subject to no-objection from AusAID/IndII. DJPK will manage the sAIG funds as part of their national budget and authorise payments through the Special Account at Bank Indonesia (BI) as well as report on the use of the funds to AusAID.

#### **3.1 What alternative development approaches are being considered? If one particular approach is favoured, what is the rationale for it?**

Three alternative approaches were considered: (i) channelling the funds through the technical ministry, MPW; (ii) a DAK type project with possible enhancements; and (iii) a grant to LGs either output or performance based.

Channelling of the funds through MPW would flow on as indirect sanitation improvements to communities at LG. It also runs counter to the current decentralisation objectives which are to enhance the transfer of funds to LG for sanitation. The MPW budget is already at the limit of MPW capacity to implement and no further consideration was given to channelling funds via MPW.

Examining the DAK concept as an option raises other issues. The DAK is in the form of a budgetary entitlement to LG. This would mean that the grant would be passed on to the LG as a budget allocation for the LG to spend and for Gol to subsequently acquit to AusAID. This is a highly risky modality and the governance mechanisms are not in place to allow its consideration. Nevertheless

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<sup>16</sup> The document is an NPPH – Naska Perjanjian Penerima Hibah – literally an on-granting agreement signed between the head of LG and the Minister for Finance.

the WB DAK initiative has many good features and its implementation should be monitored to examine possible cross fertilisation of methodologies and approaches with the grant mechanism.

A significant improvement on the DAK model is the non-output-based (conventional) grant mechanism which requires LGs to sign a binding grant agreement which can be enforced with penalties for non-compliance. This has better governance provisions than the DAK but also requires considerably more implementation oversight and obligatory prior review of supporting documents for all payments. The GoI is using this modality for education grants, and other central grant transfers.

A hybrid of this modality combined with performance assessment was used for the sanitation IEGs. The complexity of implementing the IEGs confirmed that this level of oversight and supervision of the implementing agencies can be a limiting factor in its use. It also exposed weaknesses at LG in service delivery and governance in the sanitation sector.

As a result of this assessment and the lessons learned from the sanitation IEGs, the preferred approach for delivery of sAIG is the GoI grant channel using an output-based modality as has been used successfully in the Sanitation Hibah<sup>17</sup>.

### **3.2 What project components are being considered? Can indicative costs be identified?**

The proposed modality for the sAIG is to award the grants to LGs for a period of three years to reimburse up to 55% of the agreed unit cost of implementing fixed sanitation infrastructure from a restricted menu of options. Selection of the LGs for entry into the program will be based on some agreed assessment of LG performance. Assessment of the performance for the award will include governance criteria which may cover some of the following: (i) fair financial audit by BPK; (ii) no pending negative governance issues for the LG; (iii) existence of a municipal website with access to information of LG budgets and programs; (iv) evidence of good procurement practice; (v) evidence of satisfactory performance in the sanitation IEGs or Sanitation Hibah; (vi) other GoI criteria such as commitment to the PPSP program. The LGs will implement the program using LG funds. The disbursement of the grants will be done periodically or annually based on the achievement of agreed and verified outputs for sanitation infrastructure.

The award of the grants will be formalised in an on-granting agreement which will include a schedule for implementation of the proposed program over three years. The on-granting agreement will also require the achievement of progressive governance milestones over the three year period of the grant. These milestones will include procurement quality, information transparency, and access to the public for lodgement and resolution of complaints. The award of the grants is reviewed during the three year implementation against overall performance of the LGs including governance milestones and may be adjusted up or down through reallocation to good performing LGs from poor performing LGs.

It is likely that the first year program will contain readily achievable governance requirements to help establish relationships and provide confidence to LGs, with more onerous governance criteria in subsequent years. Implementation arrangements and the level of funding support will be defined in a Funding Agreement between GoI and AusAID.

The menu of options will be restricted<sup>18</sup> to fixed infrastructure and will include small scale communal sewer schemes serving about 100 households; communal sanitation and bathing facilities; communal septic tanks serving several households; solid waste collection points; and solid

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<sup>17</sup> The Sanitation Hibah is an output-based grant program in which the LG invests equity in a sewerage operating authority which in turn applies those funds in addition to its own funding to expand sewerage connections. The grant is then disbursed to the LG based on evidence of new sewer connections having been made in accordance with agreed specifications and recipient targeting. The application of the sanitation hibah is limited to existing sewer schemes with operating sewer authorities.

<sup>18</sup> The menu will be restricted to standard sanitation and solid waste infrastructure investments but the LG will be free to choose from this menu in accordance with their need and previous programming.

waste sorting and recycling facilities. The menu of options and the applicable grant will be agreed with GoI during the design phase. The solid waste interventions may be delayed into year 2 of the program to better assess the sector.

The GoI PPSP initiative covers 330 cities. The roll-out of the PPSP is expected to be complete by 2014 as shown in the attached table. It is anticipated that the sAIIIG could cover up to 50 LGs over a three year period allowing six months start-up and six months for completion and exit.

GoA FY	2011-12		2012-13	2013-14		2014-15
GoI FY	2011	2012	2013	2014	2015	
CSS Complete	114	176	248	330		
IndII sAIIIG LGs	start	30	40	50	exit	
Current LG Inv*. \$ mil		3	4	5		
sAIIIG \$ (mil)	start	12	16	20	exit	
LG inv. Leveraged by sAIIIG		24	32	40		

\* excluding operating expenditure and salaries

The sanitation IEG program provided an average of \$250,000 to each LG for essentially a one year implementation period. In the sAIIIG, the inclusion of small scale sewerage will increase the grant size to approximately \$400,000 for each LG, each year. The application of the program over multiple years could result in average grants of \$1.2 million for each LG over 3 years. There will be 114 LGs that would qualify for the sAIIIG by the end of 2011. These are the 65 existing LGs with CSS and the 49 additional LGs with CSS in preparation during 2011. The LG selection and grant allocation criteria will aim to arrive at about 20% of qualifying LGs progressively entering the program during this period. Based on these figures a total sAIIIG allocation of \$40-\$50 million over 3 years would leverage approximately a 400% increase in fixed sanitation infrastructure in the participating LGs.

The sAIIIG will also include a public diplomacy and communications component. Implementation of the Water and Sanitation Hibah has demonstrated that this is an effective tool in emphasising the constituency benefits of the program to the heads of LG.

#### 4 Potential risks and mitigation

The use of the output-based modality will significantly reduce risks on the application of the grant. The full extent of the risk profile of the activity will be better known as the implementation of the sanitation IEG activity progresses through 2011. There are indications at this stage of some risks in the use of the IEG funds. Adequate safeguards are in place to detect and intervene in the misuse of grant funds but such intervention increases the possibility of non disbursement of the allocated funds. Many of these risks are related to procurement and implementation aspects under the current modality. The shift to output-based delivery of the grants will reduce the procurement risks but not eliminate them. Construction quality will also remain an issue. For those reasons procurement quality will be one of the key governance milestones in the grant agreements and a central requirement for LGs retaining the grant awards. Construction quality will be addressed through dedicated field supervision and periodic prior review of the handover of completed works through independent consultants engaged under IndII contract. Post-procurement audits will be carried out periodically by the independent review consultant. The full engagement of the Technical Ministry will form part of the governance development objective.

Additional monitoring and oversight will be achieved through a publicly accessible web site promulgating the program and the award of grants to LGs. Such websites have served as effective

tools for good governance in PNPM, PAMSIMAS, and other projects. LGs will be required to establish sAIIG specific websites or prominent sAIIG content in their own websites to disseminate at a minimum, status of implementation, tenders, and results of procurement.

Cooperation with the World Bank project for DAK reimbursement will examine the possibility for future use of the BPKP as the independent verifiatory as the grant program scales up. It will also identify common or complementary intervention methodologies that might migrate from one program to the other.

The option of multi-year implementation will allow adjustments to grant allocations between LGs based on annual reviews of performance. Each LG will also be able to adjust its use of the grant from year-to-year to make up any applications not approved for reasons of non-compliance with standards or quality. These options will greatly reduce the risk of non-disbursement of the grant and allow flexibility for LG to adjust to annual variations in budget resources.

Under this modality, both Gol and AusAID/IndII will have significant prior experience with the application of the Water Hibah, Sanitation Hibah and sanitation IEGs to adequately identify and manage risks associated with the sAIIG.

The sAIIG model and modality does not threaten any stakeholder interests, rather it is highly complementary to the current policy environment and is strongly endorsed by DGHS, MoF and Bappenas.

DGHS has committed considerable resources to implementing the IEG as well as the Water and Sanitation Hibah. DGHS see the IEG program as a strong tool to encourage better governance in the sector under a decentralised environment. Indications to date are that DGHS will continue to commit resources for the implementation of the sAIIG.

## **5 Issues on which guidance is sought**

Guidance is sought on overarching issues governing the funding agreement and establishment of the special account in Bank Indonesia (BI). Recent changes within Gol prevent BI from making direct disbursements to LG. This is now done through an intermediary government bank. Guidance is also sought on the possibility of establishing dual IDR and A\$ accounts at BI to allow flexibility of managing currency exchange rates. The possibility of rolling over residual funds<sup>19</sup> from the IEG program to the sAIIG is also a matter to be considered.

## **6 Proposed preparation schedule, team composition, and budget estimate**

Preparation of the sAIIG will be conducted as an IndII Phase 2 activity. Preliminary discussions have started with the Gol and an outline concept of the sAIIG design has been explored. The DGHS has agreed to form an inter-ministry design team to work with IndII. Preparation is expected to be complete by December 2011.

IndII will engage external resources to support the preparation process. This is likely to be a team of selected individual experts, or a firm. The estimated cost of the preparation activity is approximately \$150,000.

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<sup>19</sup> At present approximately \$300,000 is identified as non qualifying expenditure and an additional \$150,000 credit from exchange rate gains.

## Water Hibah

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*This concept note outlines the context and rationale for an extension of the Water Hibah. Following the pilot program's success in 2010/11, the Water Hibah will be scaled-up to \$80 million over four years (from 2011/12) resulting in approximately 250,000 water connections. Peer review approval will allow the existing design of the Water Hibah to be implemented in 2012 with a redesign to be undertaken in early 2012 to account for lessons learned and recommendations of the April 2011 evaluation.*

## **1 Key development issues and rationale for AusAID involvement**

The Government of Indonesia (GoI) is highly motivated to achieve the Millennium Development Goals (MDGs) for the water sector. This will require 68% urban piped water coverage and 20% rural piped water coverage by 2015. The current coverage levels from Director General Human Services (DGHS) are 44% and 12% respectively. These figures include non-water utility (PDAM) supplies which are estimated to serve about 8 million customers or approximately 25% of the urban population. The MDG target is ambitious and achievable only by the combined efforts of all stakeholders.

### **1.1 How would the proposed grant program / project support government's objectives, policies, and strategies in the sector?**

The Water Hibah directly supports GoI's aims to meet the water sector MDGs. Responsibility for delivery of water services has been decentralised. As such, the most sustainable outcomes will be achieved if the primary initiative comes from the Local Governments (LGs). At present GoI provides approximately IDR 3 billion annually to the water sector through the DGHS National budget (APBN). This is disbursed through the DGHS Bantuan Teknis (Technical Assistance) and BanPro (Program investments). The overall investment needs are estimated by GoI to be IDR 78 trillion (\$8.6 billion). Of that a significant portion is expected to come from PDAM generated revenue, the PerPres 29 lending program, and the private sector. Little emphasis is placed on the LG direct contribution. The Water Hibah directly addresses this aspect by making the grant contingent on LG investment in the PDAM.

### **1.2 What is the evidence of the partner agency's commitment to and ownership of the relevant policies and strategies?**

GoI has demonstrated strong commitment to the development of sector policies and strategies. The issue is how GoI will commit financial resources to achieve its sector goals. At the heart of the matter is the allocation of national funds to the sector which is a purely a LG responsibility. Ministry of Public Works (MPW) has traditionally been the recipient of large annual budgets for water and sanitation development. These stopped with decentralisation, but MPW has retained some 'responsibility' for the sector through dekon funding and tugas perbantuan<sup>20</sup>

The Water Hibah (and its success to date) has been strongly embraced by GoI. The final evaluation report for the first phase of the activity noted that "the success of this program has resulted in extremely strong interest and support by key stakeholders particularly GoI".

### **1.3 How would the proposed grant assistance support the relevant AIP-CS objective(s)?**

The Water Hibah supports AIP-CS Pillar 1 Sustainable growth and economic management; Pillar 2 Investing in people, and Pillar 3 Democracy, justice and good governance. This support comes through the direct benefit to poor households with access to a reliable and economic water service, and through improved governance and sustainability of services by LG.

### **1.4 What are the main lessons from previous studies, technical assistance and other donor support?**

Previous donor support has been mostly non sustainable. External funding into the sector has not been sustained by the recipient LG. This has largely been due to central government sustained funding with no responsibility to LG. The decentralization initiatives pointed to LG as the main stakeholder and driver of sector development. This has been born out by recent studies from the World Bank WASAP program which laid the foundation for the Water Hibah design.

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<sup>20</sup> This is a national budget allocation that is meant to balance the needs of the regions with the capacity of the regions to finance. The budget is channelled through the relevant ministries.



The Water Hibah's final evaluation report found it to be highly successful, with excellent efficiency and effectiveness. It had good sustainability (with scope for excellence in future phases). However the evaluation report outlined a number of areas for further consideration including how best to align follow on programs with budget cycles (and allow greater flexibility), improve sector monitoring and evaluation and increased attention to related activities (such as community education activities).

### **1.5 What are other development partners doing and how does the proposed AusAID assistance fit with this?**

Multilateral Development Bank (MDB) lending to the sector has stagnated because subsidiary loans can no longer be made to PDAMs. Subsidiary loans must be channelled through LG, and there are more stringent conditions for GoI commitment to subsidiary loans. Under the present institutional and regulatory arrangements both demand from LG for subsidiary loans and willingness to provide them by MoF have all but disappeared. The new on-granting regulations offer the first clear channel for transferring both external grants and loans as grants to LG. The World Bank has tried OBA support to PAMJaya DKI, and PDAM Surabaya but these programs preceded the on-granting regulations and have more complex and unworkable arrangements. Other donors are now turning to the on-granting mechanism linked to output-based payments as the model of first choice.

This Water Hibah pilot generated significant interest from other donors (such as the World Bank and the ADB) in utilising the mechanism to channel funding. Most recently USAID has embarked on a \$10 million program using the Water Hibah approach.

### **1.6 What Additionality will Water Hibah funding bring?**

The Water Hibah grant is sized to provide approximately 40% of the full cost of development of new connections. It represents about 65% of the marginal cost of extending the network for new connections. The Water Hibah design requires the LG to invest equity into the PDAM equal to or greater than the grant. While most LG invested funds equal to the grant some invested in excess. The requirement to invest is a strong positive initiative from LG. Historical data shows that LGs are investing in PDAMs. Where investment has occurred invariably it has led to sustainable improvements in service delivery over the medium term.

### **1.7 What is the evidence of the partner agency's (i) commitment to implementing reforms and improving governance (ii) preparedness to work on project preparation?**

The partner agencies, DGHS, MoF, and Bappenas were initially sceptical about the Water Hibah output-based design. Through their full involvement in the design they have become strong supporters. This belief has strengthened further when the success of the Water Hibah approach became evident. The DGHS has established a fully staffed CPMU to manage the Water Hibah and is using its own resources and funding to administer the program. Now DGHS also wants to link more difficult programs to the Water Hibah to gain traction for these lagging initiatives. The Minister of Public Works has endorsed the program and has redirected a WB loan for irrigation through the hibah mechanism.

## **2 Proposed project development objective(s)**

The project development objectives are:

- (1) Increase LG investment on water infrastructure towards meeting the GoI and MDG water service targets.
- (2) Improve governance of the sanitation sector at LG by increasing the accountability of LGs to adhere to an agreed sanitation investment program and to a level of incremental improvements to sanitation services.

### **3 Preliminary Activity Description**

The existing Water Hibah design will be implemented in 2012. A redesign of the program will be implemented from 2013. Both designs will include the features raised below.

The Water Hibah encourages LGs to invest in their PDAMs to improve public water services. The incentive component of the Water Hibah is an output-based grant to selected LGs that invest equity in their PDAMs which the PDAMs then use to expand their water supply networks. The PDAMs must further ensure that the expansion results in connections to low income households, 50% or more of which are classified as poor. The LGs receive the grant after the network expansion is complete and the new connections to poor households have been verified by an IndII appointed consultant as working satisfactorily. The size of the grant is directly linked to the number of new connections made.

The funds for the Water Hibah are provided by AusAID to the MoF under the provisions of a Direct Funding Agreement between Gol and AusAID. The Water Hibah program itself is implemented using Gol systems and procedures. The grants are provided to the LGs by MoF through new Gol regulations governing grant transfers. The program is one of the first programs to test the application of the new grant channel, and the first to apply it to water and sanitation infrastructure. The LGs must first sign "on-granting" agreements with MoF legally binding them to the implement the program. The LGs must also implement the expansion program in accordance with a Program Management Manual issued by the Gol technical agency, DGHS. As of 15 August 2011, the first phase of the Water Hibah had resulted in 76,108 connections (out of a forecasted 77,000 connections). The forward program is forecasting an additional 250,000 connections under a proposed budget of \$80 million<sup>21</sup>.

DGHS has embraced the Water Hibah program as an effective way of expanding services to poor households. The linkage to expansion for more high value customers will be done through the PerPres 29 program. DGHS will allocate preferential grants to those LG that pursue the lending program.

#### **3.1 What alternative development approaches are being considered?**

Other development approaches were considered. These were variations of conventional co-financing with MDBs to provide up front Technical Assistance support for project preparation or detailed design to complement lending by the MDB. These were ultimately rejected or relegated to lower priority based on the poor track record in recent history of such programs through Gol.

#### **3.2 What project components are being considered? Can indicative costs be identified?**

It is expected that the Water Hibah will be subject to a modest redesign in 2012 in order to include some of the lessons learned to date, recommendations of the evaluation and enhance the additionality that can be achieved from the program. Considerations will include providing capacity development support for LGs and PDAMs; extending M&E activities to better link with sectoral monitoring activities; and expanding community education activities to include water and sanitation hygiene behaviour change modules as well as information on mitigating environmental impacts.

### **4 Potential risks and mitigation**

The Water Hibah is relatively low risk. This is largely due to the output-based design and the lessons learned from the initial phase of the program. Some risks arise from the DGHS ability to identify LGs that are willing to participate. So far the demand for participation exceeds available funding. There is some risk that LGs may not be able to achieve the investment of equity to the

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<sup>21</sup> AusAID's Director General announced an \$85 million commitment (\$80 million for the Water Hibah and \$5 million for the Sanitation Hibah) over 4 years during his recent visit to Indonesia

PDAM since that involves budget approval and a DPRD regulation. Some delay can be absorbed through pre-financing by the PDAMs until the investments are made. There is also some risk that the PDAMs may not be able to finance the additional costs for making the expansions to the system. This is mitigated by allowing more frequent grant payments in tranches to facilitate cash flow at the PDAM. Procurement has been a problem with past poverty related programs. It is largely eliminated in the Water Hibah by making disbursements contingent on outputs. These outputs are verified by an independent consultant contracted directly by the IndII Facility. The verification process also eliminates risks of incorrect targeting of households or false claims for connected households by the PDAMs. Any incorrect application of the grant can be recovered through the provisions of the DFA which requires the GoI to return expenditure identified as ineligible for the grant.

DGHS has demonstrated capacity during the preparation process and ability to implement the program. It has established a fully-staffed implementation unit with a budget to conduct operational activities for management and oversight. The Water Hibah was seen initially as a threat to existing programs by DGHS but has now been accepted as valuable tool to achieve the MDG targets. Further support is envisaged to DGHS to fully institutionalise the Water Hibah concept as a nation MPW program.

## **5 Proposed preparation schedule, team composition, and budget estimate**

The preparation of the Water Hibah design in 2012 is proposed as an IndII Facility activity. It will be carried out through individual consultants engaged specifically for their sector skills and program preparation experience. The cost for preparation is estimated at \$200,000. It will require one full time senior international professional and several international and national experts covering M&E, Institutional, financing, legal, gender, environment aspects. Preparation of the design is expected to start in early 2012 for implementation in the 2013 GoI financial year.

## Sanitation Hibah

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*This concept note outlines the context and rationale for an extension of the Sanitation Hibah. The extended Sanitation Hibah will be implemented over four years from 2011/12 using its existing design. AusAID will invest up to \$5 million over this four-year period, resulting in approximately 7,000 connections. The Sanitation Hibah forms an important component of AusAID's support to the sanitation sector and complements the sAIG outlined earlier in this document. GoI supports an extension of the Sanitation Hibah.*

## **1 Key development issues and rationale for AusAID involvement**

After a long period during which sanitation services were not a priority, the Government of Indonesia (GoI) is now highly motivated to achieve the Millennium Development Goals (MDGs) for the sanitation sector. Currently, only 11 cities in Indonesia have piped sewerage networks with only 1 percent of Indonesian households having access to these sewerage networks. AusAID has a long history of providing assistance to GoI in areas of urban sanitation, particularly where GoI policy ambitions align with achieving the MDGs and increasing access to the poor. The Sanitation Hibah, an output-based program that provides incentives for Local Governments (LGs) to invest equity in their sanitation utilities to in-turn increase the number of household connections (expand services) was evaluated in April 2011 as highly successful. There is extremely strong interest<sup>22</sup> from GoI and other stakeholders in the program presenting strong foundations for AusAID to continue its involvement in the program.

### **1.1 How would the proposed grant program / project support government's objectives, policies, and strategies in the sector?**

The GoI has a national policy for the management of wastewater systems. This policy addresses themes including increasing sanitation access (prioritising the poor), increasing investment and developing alternative funding sources for wastewater infrastructure. A Sanitation Road Map, prepared jointly by Bappenas, Ministry of Public Works (MPW) and Health and Home Affairs (MoHA), presents proposals for the initial implementation phase of GoI's policy covering the period 2010-2014. Key targets for urban areas include increasing the number of cities with piped sewerage from 11 to 15; increasing the coverage of urban sewerage systems to 20 percent of the respective populations; and engaging with 330 cities / towns to prepare sanitation strategies with sound financing plans.

The Sanitation Hibah supports LGs to invest in their sanitation utilities (PDAMs or PDPALs) to expand services to poor households. The program design is tightly focused on LGs that have existing sewerage networks (only 11 cities in Indonesia) and a functioning wastewater utility in which the LG can invest equity. The eligible cities are then selected based on criteria agreed between GoI and GoA including compliance with GoI policy objectives; capacity for system expansion; agreement of LG to sign a grant agreement and comply with the requirement of the Project Implementation Manual. At this stage the program has been possible in five cities including Banjarmasin, Surakarta Balikpapan, Bandung and Jakarta.

### **1.2 What is the evidence of the partner agency's commitment to and ownership of the relevant policies and strategies?**

GoI has demonstrated strong commitment to the development of sector policies and strategies. The issue is how the GoI will commit financial resources to achieve these sector goals. At the heart of the matter is the allocation of national funds to the water and sanitation sector which is a partial LG responsibility. MPW has traditionally been the recipient of large annual budgets for water and sanitation development. These stopped with decentralisation, but MPW has retained some 'responsibility' for the sector through dekon funding and tugas perbantuan<sup>23</sup>. At present The GoI provides approximately IDR 2,900 billion annually to the sanitation sector through the DGHS National Budget (APBN). This is disbursed through the DGHS Bantuan Teknis (Technical Assistance) and BanPro (Program investments). The overall investment needs are estimated by GoI to be IDR 62 trillion (\$6 billion).

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<sup>22</sup> As reported in the Hibah Final Evaluation Report

<sup>23</sup> This is a national budget allocation that is meant to balance the needs of the regions with the capacity of the regions to finance. The budget is channelled through the relevant ministries.

The Sanitation Hibah (and its success to date) has been embraced by GoI. The Hibah Evaluation noted that “the success of this program has resulted in extremely strong interest and support by key stakeholders particularly GoI”.

### 1.3 How would the proposed grant assistance support the relevant CPS objective(s)?

The design features of the Sanitation Hibah support several “pillars” described in AusAID’s country and sectoral strategies. Specifically, the Sanitation Hibah addresses the following “pillars” as described in the country and sectoral strategies:

Australia-Indonesia Partnership Country Strategy	AusAID WASH Policy Note (Draft August 2011)	Sanitation Hibah Design Features
Pillar 1: Sustainable growth and economic management	Pillar 1: Increasing access to sanitation	Direct benefit to poor households as a result of sewerage connections
Pillar 2: Investing in people		
Pillar 3: Democracy, justice and good governance	Pillar 3: Creating sustainable services	Improved governance (LG investment in sewerage utilities) and sustainability of services (through cost recovery tariffs)

### 1.4 What are the main lessons from previous studies, technical assistance and other donor support?

Previous donor support has been mostly non sustainable. External funding into the sector has not been sustained by the recipient LG. The exceptions are Bandung and Banjarmasin, and to a lesser extent Jakarta. Other LGs have not significantly expanded their sewer systems. In some cases the systems have become defunct, e.g. Tangerang. This has largely been due to central government sustained funding with no responsibility to LG, a problem that is more acute for sanitation than water (all of the 11 existing sewerage networks are the result of central government intervention). The decentralization initiatives pointed to LG as the main stakeholder and driver of sector development and little has happened since decentralisation. This has been born out by recent studies from the World Bank WASAP program which laid the foundation for the Sanitation Hibah design.

Initial experience implementing the first phase of the Sanitation Hibah demonstrated it is considerably more restricted in its application compared to the Water Hibah. This is due to the limited number of existing wastewater utilities and lower household interest in sanitation access. However, where utilities are present, the program has delivered solid results to date (as of 15 August, the Sanitation Hibah had achieved 4,825 sewerage connections out of a targeted 5,000 connections).

The Water and Sanitation Hibah evaluation found the program to be highly successful, with excellent efficiency and effectiveness. It had good sustainability (with scope for excellence in future phases). However the evaluation report outlined a number of areas for further consideration (particularly in the case of the larger Water Hibah Program) including how best to align follow on programs with budget cycles (and allow greater flexibility), improve sector monitoring and evaluation and increased attention to related activities (such as community education activities).

Specific to the Sanitation Hibah it was noted that for more meaningful environmental impact, households should be connected in blocks or as communities (one in, all in) rather than as separate, independent units.

### **1.5 What are other development partners doing and how does the proposed AusAID assistance fit with this?**

Unlike the water sector, MDB lending to the sanitation sector through the central government is still possible and still strong. This results from continuing central government involvement in the delivery of sanitation infrastructure. In this respect, the LG is responsible for significantly less relative to the water sector. However, there is a degree of uncertainty as to how MDB funds will be dispensed (through which mechanism) and how much of the infrastructure delivered from these funds will be by the central government PU or the LG.

We note, the new on-granting regulations offer an alternate clear channel for transferring both external grants and loans as grants to LGs. Other donors are now turning to the on-granting mechanism linked to output-based payments as the model of first choice where LG is responsible for delivery.

### **1.6 What Additionality will Sanitation Hibah funding bring?**

The Sanitation Hibah grant is sized to provide approximately 40% of the full cost of development of new connections. It represents about 65% of the marginal cost of extending the network for new connections. The Sanitation Hibah design requires the LG to invest equity into the sanitation utility equal to or greater than the grant. This requirement to invest is a strong positive initiative from LG. Where investment has occurred invariably it has led to sustainable improvements in service delivery over the medium term.

### **1.7 What is the evidence of the partner agency's (i) commitment to implementing reforms and improving governance (ii) preparedness to work on project preparation?**

The partner agencies, DGHS, MoF, and Bappenas were initially sceptical about the Sanitation Hibah output-based design. Through their full involvement in the design they have become supporters of the approach. This belief has strengthened as the success of the approach became evident. DGHS has established a fully staffed CPMU to manage the Hibah and is using its own resources and funding to administer the program.

## **2 Proposed project development objective(s)**

The project development objectives are:

- (1) Increase LG investment in sanitation infrastructure towards meeting the Gol and MDG sanitation service targets. Specifically, to provide access to sewerage and on site sanitation to an additional 7,000 poor and low income households (in addition to the 5,000 achieved during phase 1)
- (2) Improve governance of the sanitation sector at LG by increasing the accountability of LG to adhere to an agreed sanitation investment program and to a level of incremental improvements to sanitation services.

## **3 Preliminary Activity Description**

The Sanitation Hibah encourages LGs to invest in their sanitation utilities to improve public sanitation services. The incentive component of the Sanitation Hibah is an output-based grant to selected LGs that invest equity in their utilities, used to expand sanitation networks. The utilities must further ensure that the expansion results in connections to low income households, 50% of

which are classified<sup>24</sup> as poor. The LGs receive the grant after the network expansion is complete and the new connections to poor households have been verified by an IndII-appointed consultant as working satisfactorily. The size of the grant is directly linked to the number of new connections made.

The funds for the Sanitation Hibah grants are provided by AusAID to MoF under the provisions of a Direct Funding Agreement between Gol and AusAID. The Sanitation Hibah program itself is implemented using Gol systems and procedures. The grants are provided to the LGs by the MoF through new Gol regulations governing grant transfers (PMK 168/169 2008, PP 10/2011, and PP 57/2005). The Sanitation Hibah program (along with the Water Hibah) is one of the first programs to test the application of the new grant channel, and the first to apply it to water and sanitation infrastructure. The LGs must first sign “on-granting” agreements with MoF legally binding them to the implement the program. The LGs must also implement the expansion program in accordance with a Program Management Manual issued by the Gol technical agency, the Directorate General of Human Settlements (DGHS). DGHS has embraced the Sanitation Hibah as an effective way of expanding services to poor households.

### **3.1 What alternative development approaches are being considered? If one particular approach is favoured, what is the rationale for it?**

Other development approaches have been considered and some are being implemented in parallel to the Sanitation Hibah. Given the limited number of LGs that can participate in the Sanitation Hibah program, AusAID is looking at ways for LGs that do not have sanitation utilities to access output-based grant funding for sanitation infrastructure (see the sAIG concept note). Further, approaches are being investigated to fund the implementation of wastewater master plans for up to five cities. It is expected that the majority of this will be funded by MDBs however AusAID is considering funding one of these fully. This proposal will be prepared as a separate concept also.

Variations of conventional co-financing with MDBs to provide up front Technical Assistance support for project preparation or detailed design to complement lending by the MDB have also been considered. Some of these have been pursued, however most were ultimately rejected or relegated to lower priority based on the poor track record in recent history of such programs through Gol.

### **3.2 What project components are being considered? Can indicative costs be identified?**

The second phase of the Sanitation Hibah will be focussed on two main areas, the completion of the Banjarmasin program and a possible expansion of the Bandung program. It is expected that this will result in 7,000 connections for a cost of \$5million committed in the forward planning documents.

It is not expected that the Sanitation Hibah will need redesign during the next phase of the program. Given the small number of potential LGs available to the program, it is expected that the next phase will primarily be a continuation from phase one. However, where appropriate the lessons learned to date, as highlighted in the final evaluation report will be incorporated into the future program.

## **4 Potential risks and mitigation**

The Sanitation Hibah program is relatively low risk. This is largely due to the output-based design and the experience gained during phase 1. The main concern arises from how restrictive the program is to new participants which restricts the size of this program. So far the demand for participation has been slightly below expectation. There is some risk that LGs may not be able to achieve the investment of equity to the sanitation utility since that involves budget approval and a

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<sup>24</sup> Low income households in the Sanitation Hibah program have been defined as households with an electricity connection <1.3 KVA while poor households are those with an electricity connection <0.9 KVA



district government regulation. Some delay can be absorbed through pre-financing by the utilities until the investments are made. There is also some risk that the utilities may not be able to finance the additional costs for making the expansions to the system. This is mitigated by allowing more frequent grant payments in tranches to facilitate cash flow at the utilities. Procurement has been a problem with past poverty related programs. It is largely eliminated in the Sanitation Hibah by making disbursements contingent on outputs. These outputs are verified by an independent consultant contracted directly by the Facility. The verification process also eliminates risks of incorrect targeting of households or false claims for connected households by the utilities. Any incorrect application of the grant can be recovered through the provisions of the DFA which requires the GoI to return expenditure identified as ineligible for the grant.

The DGHS has demonstrated capacity during the preparation process and ability to implement the program. It has established a fully staffed implementation unit with a budget to conduct operational activities for management and oversight. The Sanitation Hibah was seen initially as a threat to existing programs by DGHS but has now been accepted as valuable tool to achieve the MDG targets.

## **5 Proposed preparation schedule, team composition, and budget estimate**

The Sanitation Hibah will implement the existing design in 2012. LGs intending to participate in the initiative will need to make the appropriate allocations in their 2012 budgets in October 2011.

## Cross Cutting Issues

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The discussion below on cross-cutting issues is applicable to all three Water and Sanitation Grants programs (Water Hibah, Sanitation Hibah and Sanitation AIIG). The detailed integration of these cross-cutting issues in forthcoming designs will be informed by relevant AusAID advisers and IndII specialists.

### **Gender:**

The whole community, including women, men, children, the elderly and people with disabilities stand to be significant beneficiaries of these programs. The recent Water and Sanitation Hibah evaluation found that women and people with disabilities benefited in terms of time and money savings, improvements in quality of life and health as a result of having water/sewerage connections. Women reported having good access to information on the program and were the main individuals approaching utilities for connections. As we move forward to re/designing these programs, we will pay particular attention to the following:

1. **Awareness raising:** There is a general lack of public awareness and interest in improving access to clean water and especially sanitation. For the hibah programs, we will continue to distribute brochures/pamphlets to newly connected households on how to get the most use and benefit out of their new water/sewerage connection. We will also consider working with LGs to raise community awareness about the importance of water, sanitation and hygiene including benefits to health, privacy and productivity.
2. **Appropriate consultation and decision making:** Previous urban sanitation projects have found that women need to be consulted for their concerns and preferences regarding sanitation infrastructure. We will look into ways of working with LGs to ensure their decision-making about community infrastructure (such as public toilets) have considered the interests of the whole community, especially women, elderly and people with disabilities.
3. **Communication plans:** Closely linked to points 1 and 2 above, we will consider including the preparation of LG communications/public information plans as a condition for participation in these initiatives. Such plans would outline how LG intends to disseminate information about its participation in the initiative/s and supply contact details for constituents to provide feedback.
4. **Engendering infrastructure:** We will look into including certain M&E indicators that will inform us about how “gender sensitive” community sanitation infrastructure is and how such infrastructure can be improved (e.g. improved standards) to better benefit women and children.
5. **Linking up with IndII activities:** There are plans to design gender-specific activities for IndII Phase 2 (for example, working with the Sanitation Working Group to think more about gender issues, involving the Women’s Ministry in activities). We will look for opportunities to link such activities with these grants programs.

### **Environment:**

The Water and Sanitation Hibah evaluation found observable environmental benefits (such as the reduction of groundwater pollution and reduced fuel consumption to boil drinking water) in areas where water and sewerage connections were made. In the case of Banjarmasin city, environmental benefits such as reducing raw sewerage and grey water into the river influenced the government’s targeting of households (as a result, a significant number of households along the river were connected to the sewer). Based on the lessons of the Hibah and sanitation IEGs, future re/designs will pay attention to the following issues:

1. **Community education:** Although there are positive outcomes as a result of having access to sewerage, we will look into working with LGs to implement some type of community education to reduce minor adverse environmental impacts as a result of new water/sewerage connections.
2. **100% connection rate:** To achieve full environmental and health benefits of sewerage connections, we will encourage LGs and sewerage utilities to aim for a 100% connection rate in each neighbourhood. While we acknowledge that this 100% target is high and unlikely to be attainable in the short-to-medium term, we see it is an aspirational target necessary for long-term change.
3. **Infrastructure locations and standards:** To minimise adverse environmental impacts, grants will not be provided for community-sanitation infrastructure in vulnerable locations and works will be required to meet technical design and environmental standards set out by Ministry of Public Works.