Summary brief of Focus Group Discussions (August – November 2008)

Mitigating and adapting to climate change requires macroeconomic management, fiscal policy plans, revenue raising alternatives, insurance markets, and long term investment options. The Ministry of Finance needs to manage these challenges by adopting budget priorities, pricing policies, and financial market rules. To this end, the Fiscal Policy Office appointed a working group on climate change (WGCC) to study and map out fiscal issues for climate change.

In 2008, the group hosted a series of Focus Group Discussions (FGDs) with experts from inside and outside the government, conducted studies on forestry and regulatory impact assessment, and initiated studies of low carbon development, geothermal energy, and institutional issues.

The overall policy objective of these FGDs was to identify key policies and sectors where carbon finance mechanisms could be best applied and seek ways to broaden and scale up mitigation initiatives using carbon finance programs. The FGD process also contributed to internal Ministry discussions to harmonize perceptions and develop action plans for dealing with key climate change issues that fall within the main areas of responsibility of the Ministry.

Several key policy conclusions arose from the discussions.

First, Indonesia can deepen its engagement on the international level to make the best possible use of global financial mechanisms to support mitigation and adaptation efforts. These mechanisms include the financial mechanisms under the UNFCCC and Kyoto Protocol framework, of which the Clean Development Mechanism (CDM) is the most important one for Indonesia. Indonesia's efforts to formulate clear strategies and roadmaps for the negotiation process are particularly important in the ongoing international efforts to install various climate investment funds. Like any other investment, successfully attracting carbon finance flows will ultimately depend on creating a conducive domestic investment climate.

Second, general fiscal and economic incentives are crucial to address the structural barriers to carbon/climate finance projects, especially in fossil fuel consuming sectors. The main barriers are distorted energy and fuel prices which prevent clear market signals to investors (CDM project developers) and in many instances make the development of renewable energy options economically unviable. Addressing these distortions, however, requires a gradual approach towards environmental fiscal reform, given that subsidies also function as a social measure to provide affordable energy. Thus, it is important to identify policy synergies, which reduce environmental externalities, but also provide social benefits and improve economic efficiency. For instance, reducing fuel subsidies and allocating the budget resources to poverty alleviation programs is one already tried successful policy option.

A third policy area is the use of specific policy incentives and fiscal instruments to address policy barriers to CDM project development. The FGDs identified the link between CDM and carbon markets to more general issues, such as the investment climate and lack of local government capacity to handle carbon finance issues. Participants also mentioned high transaction costs of the CDM project cycle and access to finance for private project developers as important barriers to the smooth development of carbon/climate finance in Indonesia. Tax treatment of CDM earnings was identified by participants and project developers as an important area of uncertainty and a barrier to emission reduction project investments.

Fourth, there are important sector opportunities to address barriers or create opportunities for expanding carbon/climate finance potential. Chief among these sector opportunities are banking, forestry and alternative energy. The role of the banking sector is seen to be crucial in improving access to finance in carbon/climate finance projects. So far, the Indonesian banking sector is not much engaged in financing CDM projects. The key issue is risk perception: Certified Emissions Reductions (CERs, the tradable commodity produced from CDM projects) are still not viewed as 'real' outputs by credit analysts, thus making CERs also difficult to act as collaterals and guarantees. Bank Indonesia and Bapepam are in the process of factoring environmental sustainability into risk rating and assessment frameworks as a way to improve the awareness in the industry.

Forestry is a key sector carbon/climate finance opportunity for Indonesia. Reduced Emissions from Deforestation and Degradation (REDD) is a proposed approach to create a new carbon market to allow payments to countries that can reduce the rate of deforestation. From a fiscal perspective, REDD payments can be seen as way to capture the full value of forests by including environmental externalities from deforestation and valuing services provided by forests. However, one main concern is that the current undervaluation of forest resources combined with ineffective rent collection and monitoring will undermine future carbon prices. Addressing forest sector issues will require a multi-sector approach and the Ministry of Finance can play a crucial role in developing clear regulatory mechanisms and incentive frameworks that affect the financial side of a REDD program.

The energy sector - particularly geothermal energy production - represents an important carbon/climate finance opportunity for Indonesia. FGD participants mentioned renewable energy sources as an important area of opportunity. Of renewable resources, geothermal energy is one of the most promising because it is abundant in Indonesia and could be a focus area for designing future programmatic carbon finance and CDM incentives. One policy approach to foster geothermal energy production would be to use climate investment funds to subsidize the high up-front investment costs to build geothermal plants.

There are also opportunities for emissions reductions and carbon finance in the industrial sector. The Ministry of Industry has started to develop emissions strategies for key industries, including textiles, cement, pulp and paper and steel. However, in order to achieve substantial emissions cuts and stay competitive, it was suggested that the industries need substantial help in the form of tax exemptions and investment incentives.

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