

# Indonesia's DPR passes carbon tax as part of proposed cap-and-trade system

## Quick read

There are two important legislative developments in Indonesia as the country attempts to meet its obligations under the Paris Agreement. Indonesia's House of Representatives (*Dewan Perwakilan Rakyat* or **DPR**) has passed an omnibus bill including, among other things, a carbon tax, that now awaits President Jokowi's signature. There is also a current draft presidential regulation that outlines a larger emissions reduction framework, including a cap-and-trade system. The carbon tax will eventually be part of this emissions reduction framework. Putting in place this framework is a step towards meeting Indonesia's treaty obligations, but structured and coordinated implementing regulations will be necessary to establish both the carbon tax and the cap-and-trade system as effective policy. The carbon tax and cap-and-trade system may eventually impact key sectors of the economy and every level of government.



## Indonesia's Paris Agreement Obligations

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The Paris Agreement (the **Paris Agreement**) is a global treaty under the United Nations Framework Convention on Climate Change that aims to limit the global average temperature increase to 2°C to 1.5°C above pre-industrialised temperature levels. The core of the Paris Agreement is the nationally determined contribution (**NDC**), a document that contains each signatory's plan for achieving its required greenhouse gas (**GHG**) emission reductions under the Paris Agreement. Indonesia ratified the Paris Agreement in 2016, committing by treaty to limit its own GHG emissions. Indonesia's NDC<sup>1</sup> sets out that the government of Indonesia will establish a national baseline for GHG emissions (the business-as-usual level of emissions, i.e., without any mitigating policy interventions), which will be the basis for calculation of GHG emission reductions. The NDC estimates baseline and planned emissions reductions from each of the following economic sectors:

- energy;
- waste;
- industrial processes; and
- forestry and land use,

(the **Sectors**).<sup>2</sup>

The NDC's overall target is a GHG emissions reduction of at least 29% by the year 2030, as compared to business-as-usual. The NDC estimates that the percentage reduction equals 834 million tonnes of carbon dioxide (or its equivalent – nitrous oxide and methane are more climate intensive GHGs) per year.

## Emissions Reduction Framework

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Currently, a draft Presidential Regulation<sup>3</sup> (the **Draft PR**) sets out an emissions reduction framework that aims to implement the NDC target. The Draft PR's primary policy for achieving the NDC target is a system of emissions trading and emission offsets (i.e., a cap-and-trade system), though the Draft PR

also contemplates "carbon levies" as part of the cap-and-trade system.<sup>4</sup> Although the Draft PR is still under discussion, the DPR has passed a bill that covers carbon tax, which now awaits President Jokowi's signature. We discuss the details of the overall emissions reduction framework, the carbon tax and the cap-and-trade system below.

Under the Draft PR, the Minister "in charge of governmental affairs in the field of environmental protection and management" (the **MOEF**)<sup>5</sup> is responsible for coordinating the national implementation of mitigation (i.e., emissions reductions) and climate change adaptation. The Draft PR sets out that the MOEF will establish a national baseline for GHG emissions, including Sectoral baselines (in consultation with the relevant ministries), as well as baselines for every level of government. The PR authorises the MOEF to stipulate reduction targets from the baseline for each Sector, based on the NDC's overall emissions reduction target.

## Carbon Tax

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The Bill Concerning Harmonization of Tax Regulations (*Rancangan Undang-Undang Tentang Harmonisasi Peraturan Perpajakan* or the **Tax Bill**) includes a tax on "carbon emissions that have a negative impact on the environment".<sup>6</sup> The Tax Bill explicitly contemplates the carbon tax being part of the larger cap-and-trade system. Taxpayers who participate in emissions trading may receive a reduction of carbon tax, as regulated by the MOF.<sup>7</sup>

The tax is payable on (a) the purchase of goods containing carbon and (b) activities that produce GHG emissions. The tax rate is set to be "higher [than] or equal to the carbon market price per kilogram of carbon dioxide or its equivalent". The *minimum* carbon tax rate is set at Rp 30 per kilogram (USD2.11 per tonne) of carbon dioxide or its equivalent. The goods tax will be due at the time of purchase, and the activities tax will be assessed annually. Taxable goods containing carbon include, but are not limited to, fossil fuels. Activities that produce carbon emissions in the target Sectors are taxable as well.

1 The Ministry of Environment and Forestry Directorate General of Climate Change submitted Indonesia's updated NDC in July 2021.

2 The Draft PR (as defined in later in this client alert) defines "sector" as the "NDC sectors which have a field of activity where GHG emissions occurred." Article 7 of the Draft PR refers to these sectors as: (a) energy; (b) waste; (c) industrial processes and product use; (d) agriculture; (e) forestry; and/or (f) other sectors according to the development of science and technology. Sub-sectors consist of generation, transportation, industry, buildings, rice fields, livestock, plantations, forestry, solid and liquid waste, garbage and other subsectors according to the development of science and technology. Other sectors and sub-sectors shall be stipulated by the MOEF (as defined below) after coordinating with the relevant ministers and/or heads of non-ministry government agencies.

3 Draft Presidential Regulation on the Instrument for the Economic Value of Carbon for Achievement of the NDC and Control of Carbon Emissions in Development (*Instrumen Nilai Ekonomi Karbon untuk Pencapaian Kontribusi Yang Ditetapkan Secara Nasional dan Pengendalian Emisi Karbon Dalam Pembangunan*).

4 The NDC and the Draft PR also contain provisions for (i) low carbon development planning and (ii) payments for reductions that do not lead to transfer of carbon ownership (such as government entities). These policies, together with the carbon tax and cap-and-trade system discussed here, form the core of Indonesia's NDC roadmap. These policies are complicated subjects in and of themselves and are beyond the scope of this client alert.

5 The Draft PR uses this formulation, but does not clearly identify this minister as the Minister of Environment and Forestry. However the Ministry of Environment and Forestry uses this formulation in its own regulations.

6 Criteria for negative impact on the environment include natural resource depletion, environmental pollution or environmental damage.

7 The carbon tax is properly part of the larger emissions reduction framework, otherwise the baseline emissions calculation would need to already reflect in the reductions resulting from the tax.

Details remaining subject to further Ministry of Finance (**MOF**) regulation also include the procedures for calculating, collecting, paying or depositing, and reporting the tax, and the mechanism for imposing the carbon tax. Other matters for further Government Regulation by the DPR include determination of entities subject to the tax and the allocation of revenue from the carbon tax for climate change control. As we note below in our discussion of further regulation, these details will be key to the successful implementation of the carbon tax.

## Carbon Trading Regime

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As mentioned above, the Draft PR authorises the MOEF to stipulate reduction targets from the nationally determined baseline for each affected Sector, based on the NDC's overall target.<sup>8</sup> Each Sector would then allow a certain amount of GHG emissions from each regulated entity within that Sector. Under the Draft PR, a regulated entity that reduced its emissions below its GHG emission allowance would be entitled to register "offsets" with the climate national registry system (*sistem registri nasional pengendalian perubahan iklim* or **SRN**)<sup>9</sup> and receive emissions reduction certificates (*sertifikat pengurangan emisi karbon* or **SPEKs**), corresponding to the amount of carbon reduced below its allowance. In this cap-and-trade system, SPEKs are the instrument for GHG emissions reduction.<sup>10</sup> A regulated entity that could not reduce its own GHG emissions below its allowance would be able to purchase SPEKs corresponding to the required reduction and still be compliant with its regulatory obligation to reduce GHG emissions. Theoretically, all regulated entities in each Sector together as a whole would achieve the Sectoral goal stipulated by the MOEF. Ministerial implementing regulations will more fully set out which entities in each Sector are subject to GHG emissions limits, and what those GHG emissions limits are.<sup>11</sup>

## Further Regulation

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### Carbon Tax

The USD2.11 per tonne tax rate is a minimum, but according to the Tax Bill, the price will be equal to the market price of carbon.<sup>12</sup> The MOF will determine the actual tax rate after consultation with the DPR. We also note that the MOF has the ability to determine the administration of the tax, while the DPR will determine who is subject to the tax. Thus,

much about the carbon tax remains undetermined and concerns remain about its application.

Third party policy analysts generally agree that an upstream approach to a carbon tax (i.e., where producers and importers of fossil fuels products would pay a tax based on the carbon content of those products) is the most simple and straightforward way of implementing a carbon tax, since an upstream tax can incorporate existing methods of regulatory monitoring and reporting. However, we note that the energy market as a whole in Indonesia is already subject to various government interventions, including domestic market obligations, price caps and subsidies. The everyday consumer in Indonesia ultimately pays heavily subsidised prices for gasoline and electricity. Any increase in these types of costs may have political implications, which the government must consider in light of the economic reality after Covid-19. Thus, we look to see how the DPR will balance the impact of the carbon tax on various parts of the supply chain and the influence of vested interests.

### Carbon Trading Regime

The PR establishes a Carbon Economic Value (**CEV**) Steering Committee with the Coordinating Minister for Maritime and Investment Affairs as its head, the MOEF as its Chief Executive, and members from the Ministries of Home Affairs, Finance, Environment and Forestry, PPN/Bappenas, Energy and Mineral Resources, Industry, Transportation, Public Works and Public Housing, Agriculture, and Marine and Fisheries. The Steering Committee will be assisted by a secretariat and a technical team, and is responsible for, among other things, the "supervision of the implementation of carbon trading". Implementation of carbon trading will include regulation of offset calculation, emission offset statements, and SPEK usage. From the experience of other cap-and-trade systems, we know the Steering Committee will need to negotiate fair sectoral targets and develop well thought out rules to encourage compliance.

The experiences of Europe, China, and the United States have shown that implementing an effective cap-and-trade system is a complicated and difficult endeavour that may take years. European markets faced early problems with poorly written regulations under the Kyoto Protocol, enabling factories in China to earn approximately USD6 billion in carbon credits for destroying the refrigerant HFC 23 (a highly intensive GHG), when it would have been far cheaper (USD100m) to simply install control equipment.

8 Draft PR, Article 14.

9 Indonesia's NDC calls the SRN "the backbone of the transparency framework". According to the NDC, the SRN is targeted to be fully functional by 2030.

10 Draft PR, Article 54.

11 The Draft PR also directs the MOEF to stipulate guidelines for integrated measurement, reporting and verification of GHG emission reductions, and carbon trading must be carried out with reference to the Indonesian National Standard (ISO 14064 and ISO 14065).

12 The 2018 OECD effective carbon rate (including excise, carbon tax and permit prices) for coal was EUR13.4 per tonne, with carbon taxes equal to EUR2.5 per tonne.

A better example is California's AB32 emissions reduction framework. Under AB32, the California Air Resources Board (**CARB**) administers a cap-and-trade system that applies to electricity generators, large industrial facilities, and transportation fuel and natural gas distributors. We note that this system does not apply to sectors such as agriculture or government, but it does cover about 85% of total emissions. Early in the program, CARB set the allocation of emissions allowed for each economic sector to 90% of average emissions. CARB allocated emissions allowances for free, then transitioned to an auction system over three years. Since the full implementation of AB32 in 2012, California's population has grown, and its GDP has risen at higher rate when compared to the US as a whole, but at the same time California has managed to lower its emissions back to 1990 levels.

We note that the Ministry of Energy and Mineral Resources (**MEMR**) has begun running a pilot emissions trading program this year covering 80 power plants, including 19 generating units with a capacity of more than 400

megawatts (MW), 51 generating units with a capacity of 100-400 MW, and ten units of mine mouth generators. Of these, 54 power plants are owned by PLN and 26 are owned by IPPs.<sup>13</sup> MEMR Director General of Electricity Rida Mulyana said this step aims to support the target of cutting carbon or greenhouse gas emissions in the energy sector by as much as 314-398 million tonnes annually by 2030.

Because of the difficult negotiations ahead, we expect the CEV Steering Committee to focus on the technical details of emissions trading first. An important first step would be to accelerate the functionality of the SRN, which, according to the NDC, will not be fully functional until 2030, the same year that Indonesia is required to reduce its carbon emissions under the Paris Agreement. Successful implementation of the broader emissions reductions framework and meeting Indonesia's Paris Agreement obligations will require a high level of cooperation between all levels of government and the private sector.

13 [https://www.esdm.go.id/en/media-center/news-archives/uji-coba-perdagangan-karbon-diikuti-80-pembangkit-](https://www.esdm.go.id/en/media-center/news-archives/uji-coba-perdagangan-karbon-diikuti-80-pembangkit)

## Key contacts



**Michael Tardif**  
Foreign Legal Consultant  
(Partner Level), Jakarta  
Tel +62 21 2995 1702  
[michael.tardif@allenoverly.com](mailto:michael.tardif@allenoverly.com)



**Ari Bessendorf**  
Foreign Legal Consultant  
(Senior Associate Level), Jakarta  
Tel +62 21 2995 1706  
[ari.bessendorf@allenoverly.com](mailto:ari.bessendorf@allenoverly.com)



**Deska Widiyanto**  
Senior Associate, Jakarta  
Tel +62 21 2995 1725  
[deska.widiyanto@allenoverly.com](mailto:deska.widiyanto@allenoverly.com)