THE BIRTH OF INDONESIA'S CARBON TAX IN THE MIDST OF THE PANDEMIC AND COP26

KEY TAKEAWAY:

- *Carbon tax and trading policies, reducing the use of coal as a source of energy, and developing new and renewable energy are expected to contribute toward Indonesia's goal of net zero emissions by 2060. However, the government faces a challenging balancing act. Whilst Indonesia is committed to reducing its carbon emissions, it needs to grow its economy and maintain its competitiveness. The fundamental issue is how will the government be able to adequately finance battling both the pandemic and global warming.*
- *The economy is weakening as a result of the pandemic, which seriously affected the government's economic growth and development goals. The pandemic put additional pressure on the state budget which will affect how much can be devoted to tackling the reduction of global emissions. Doing nothing to address climate change is not an option as multinational companies and investors are taking it seriously; what a country does to mitigate carbon emissions has become a significant factor in their decision-making. To attract foreign investment and compete globally, Indonesia needs to comply with global environmental standards and significantly improve its healthcare system; but these will require adequate funding.*
- *Indonesia and other developing countries declared at the COP26 conference that they require external financial and technological assistance in order to meet their objectives and NDC targets. As part of the Paris Agreement, developed countries agreed to provide USD 100 billion annually to less developed countries for their climate change efforts. However, that goal has not yet been reached and it is expected to take at least another two years to achieve this goal, with most of the financing likely coming from loans.*
- *The introduction of the new carbon tax will change the strategy of the industry players in Indonesia as they adapt to the new regulatory environment. Companies which operate in the targeted sectors may need to revisit their long-term strategies to take into consideration the potential effect of the carbon tax and future changes it could have on their business.*

Background: Commitment to reduce global emissions

A carbon tax was introduced in the recent Harmonization of Tax Regulations Law as part of Indonesia's commitment to reduce its global greenhouse gas emissions and encourage the development and use of green technology. *(See our New Alert No. 4/2021 for a discussion of the new law.)*

Indonesia pledged to reduce its global emissions when it signed the Paris Agreement in April 2016. This action was ratified through Law No. 16/2016. In July this year, Indonesia submitted its updated Nationally Determined Contribution (NDC) to the UNFCCC reaffirming its commitment to *unconditionally reduce emissions by 29% by 2030*. This reduction is *increased to 41% if Indonesia is provided international support in the form of funding, technology, and capacity building*. The goal is to *reach net zero emissions by 2060*. To achieve this, five sectors will be focused on: energy and transportation, agriculture, forestry and peat lands, industry, and waste treatment sectors *(as further stipulated under Presidential Regulation No. 98/2021 as the implementing regulation of Law No. 16/2016).*

Indonesia's new carbon tax is intended to encourage companies to reduce their carbon emissions. Although there are a number of approaches governments can use to reduce greenhouse gas emissions, a carbon tax is relatively straightforward, is administratively easy, and provides additional revenue to the government. The revenue generated can be allocated to climate change control, such as activities to reduce emission levels or increase absorption of emissions.

The key points of the carbon tax are:

- The carbon tax is set at a minimum of IDR 30/kg (IDR 30,000/ton) of carbon dioxide equivalent (CO2e).
- The carbon tax will be carried out in stages, based on a roadmap which is to be developed.
- As the initial phase, the tax will apply to the coal-fired power plant sector beginning 1 April 2022.
- The tax is payable at the time carbon-containing goods are purchased or at year end for carbon-producing activities.
- A carbon trading mechanism will be developed.

Some in the business community are concerned that this carbon tax will be burdensome and add costs to the targeted industry sectors, making them less competitive. Others argue that the tax itself is too low and unlikely to create any significant change. It remains to be seen what effect the carbon tax and the carbon trading scheme will have on the economy and to what extent it will help Indonesia meet its NDC target.

Carbon tax rate

The carbon tax is imposed on carbon emissions which negatively impact the environment. The tax rate is set at higher than or equal to the carbon price in the carbon market, with a minimum of IDR 30/kg CO2e, or approximately USD 2.1/ton CO2e. This is one of the lowest tariffs among countries which have a carbon tax. However, this is the minimum rate and may be increased by the Minister of Finance after consultation with Parliament.

The calculation of tax payable will take into account the emission factor value as determined by the competent ministry or agency. This value relates the average amount of emissions released into the atmosphere from certain sources relative to the unit of activity or process related to the release of carbon emissions.

Will the tax be sufficient to encourage companies to reduce emissions and switch to renewable energy, or will they simply pay the tax as an additional cost of doing business? Will the revenue generated by the tax be sufficient to allow the government to invest in climate change projects? Given that the government already subsidizes the price of electricity, will the additional cost imposed on electricity generation be borne by the government or the consumer?

Carbon tax subject

The carbon tax is payable by an individual or entity which buys carbon-containing goods or engages in activities that produce a certain amount of carbon emissions in a certain period. However, the priority will be corporate tax subjects rather than individuals.

The tax is payable:

- at the time of purchasing carbon-containing goods;
- at the end of the calendar year period for activities that produce more than a certain amount of carbon emissions; or
- as otherwise regulated.

The tax will initially apply only to companies that operate coal-fired power plants. This will begin 1 April 2022 at the rate of IDR 30/kg CO2e. Although there are no exceptions for companies which use emissions-reducing technologies, the more efficient the power plant is, the fewer emissions it will generate and, consequently, the less the carbon tax it will have to pay.

Carbon tax roadmap

Implementation of the carbon tax will be based on:

a) the government's carbon tax roadmap, which includes:

- ✓ a carbon emissions reduction strategy
- ✓ priority sector targets

- ✓ alignment with new and renewable energy development
- ✓ alignment with various other policies

and/or

b. the government's carbon market roadmap, which is not further explained in the law.

These roadmap policies will be determined by the government with the approval of Parliament.

The carbon tax will be imposed in stages, as follows:

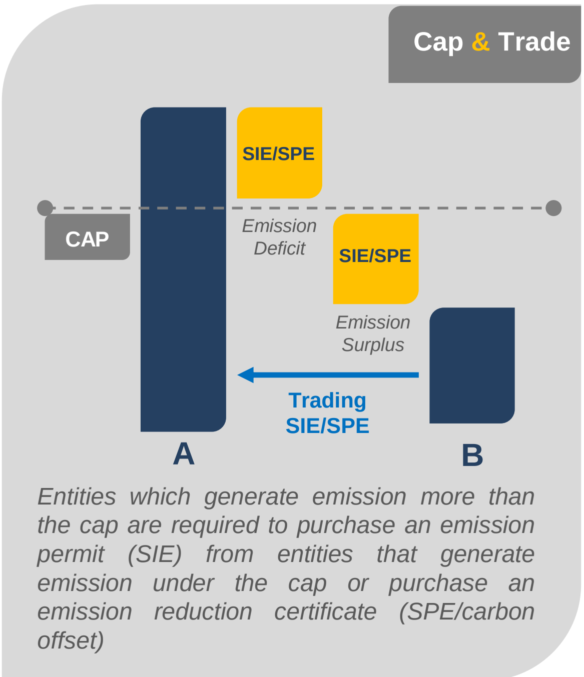
2021
- Develop a carbon trading mechanism.

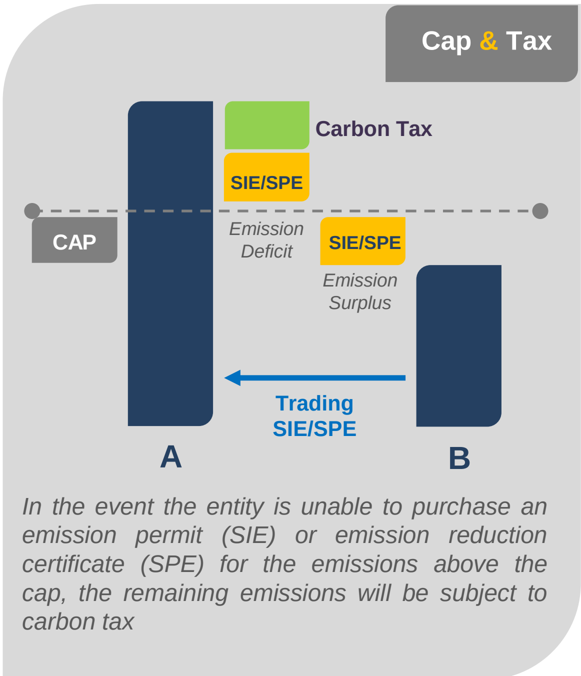
2022-2024
- Apply a tax mechanism based on emission levels to coal-fired power plants.

2025
- Full implementation of carbon trading and application of the carbon tax to other sectors, taking into account issues such as economic conditions, readiness of the industry players in the relevant sectors, and expected impact.

Carbon trading/offset

Taxpayers will be taxed if they exceed the emissions threshold. However, they can trade carbon emissions, offset carbon emissions, or participate in other mechanisms which might be offered in order to receive a carbon tax reduction or other benefit. Below is an explanation as provided by the Ministry of Finance:





Our understanding of the general mechanism is that a cap will be established for acceptable emissions. Any emissions above the cap will be subject to the carbon tax. Entities which emit more than the cap may be able to purchase a carbon emission offset in some form from entities which emit less than the cap or engage in emission reducing activities. Further details are to be provided in future regulations.

This mechanism is in line with the international approach. However, there are a number of difficult issues that will need to be addressed. For example, governments have had difficulty reaching a consensus on rules for carbon trading among nations under Article 6 of the Paris Agreement. A major issue at COP26 involved creating an appropriate accounting mechanism which avoids double counting of the reduced emissions by allowing more than one country to take credit for the same reduction in emissions. Another issue is whether countries that have earned carbon credits under the Clean Development Mechanism (under the 1997 Kyoto Protocol) can apply these towards their NDC targets under the Paris Agreement.

Indonesia will need to address similar types of issues as it develops its domestic “cap and trade” and “cap and tax” mechanisms. It will be interesting to monitor how the government determines the carbon trading price and how this trading and tax mechanism will work in practice.

Reduce use of coal

Indonesia currently is highly reliant on coal for its energy. However, the government is aware of the need to reduce its reliance on coal in the future and switch to new and renewable energy to the extent possible. This is evidenced by a number of steps taken in recent years, such as:

- Indonesia established, as a national policy directive, a mixed-energy use policy to encourage the use of clean energy sources. The 2014 National Energy Policy states that at least 23% of Indonesia’s energy will be sourced by new and renewable energy by 2025 and at least 31% by 2050.
- According to PLN’s recently released 2021-2030 Electricity Supply Business Plan (RUPTL), Indonesia will reduce its reliance on coal even further in the coming years. The RUPTL states that by 2030 51.6% of a planned 40,575 MW of power plant projects will be new and renewable energy projects (mainly hydro, solar, and geothermal), while the remaining 48.4% will be from fossil fuel.
- Based on the RUPTL, the government plans to retire coal-fired power plants starting from 2030 and be carbon neutral by 2060.
- Leaders at the recent G20 summit in Rome agreed to stop public financing of overseas coal-fired power plants.

If these targets can be met, Indonesia will be on the path to decarbonization. However, becoming carbon neutral will not be easy. The government and stakeholders will need to make adjustments to their strategies and adapt to the new reality.

For additional information, please contact us:

Sony B. Harsono, Managing Partner
sony.harsono@harsono-strategic.com

Dwi Ary Retnani, Senior Partner
dwiary.retnani@harsono-strategic.com

Julius Hardianto, Senior Partner
julius.hardianto@harsono-strategic.com

Suhartono Maridjan, Senior Partner
suhartono.maridjan@harsono-strategic.com

Budi Harnata, Partner
budi.harnata@harsono-strategic.com

Richard William, Partner
richard.william@harsono-strategic.com

Roedy Andrianto, Director
roedy.adrianto@harsono-strategic.com

Sandy Tanu Utomo, Director
sandy.utomo@harsono-strategic.com

Terri Shreve, Technical Advisor
terri.shreve@harsono-strategic.com

Toshihiro Asai, Technical Advisor
toshihiro.asai@harsono-strategic.com

Harsono Strategic Consulting
Sudirman Plaza, Plaza Marein 9th Floor
Jl. Jend. Sudirman Kav. 76-78
Jakarta 12910, Indonesia
ph. +62 21 5793 6777
fax. +62 21 5793 6778
www.harsono-strategic.com

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