

TAR: NAU 39072

Technical Assistance to Nauru
for the Reform of the Nauru
Phosphate Corporation
(Financed by the Government
of Australia)

May 2005

CURRENCY EQUIVALENTS

(as of 25 April 2005)

Currency Unit	–	Australian dollars (A\$)
A\$1.00	=	US\$1.281
US\$1.00	=	A\$0.780

ABBREVIATIONS

ADB	–	Asian Development Bank
AusAID	–	Australian Agency for International Development
NPC	–	Nauru Phosphate Corporation
SOE	–	state-owned enterprise
TA	–	technical assistance

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	–	General intervention
Sector	–	Energy
Subsector	–	Energy sector development
Themes	–	Sustainable economic growth, governance, private sector development
Subthemes	–	Promoting economic efficiency and enabling markets, financial and economic governance, public-private partnerships

This report was prepared by C. Litwin.

I. INTRODUCTION

1. The Government of Nauru has embarked on a process of broad-based public sector reform. Rightsizing and restructuring of state-owned enterprises (SOEs) have been identified as priority areas in the reform process. Following a request from the Government for technical assistance (TA) to support SOE reform, an Asian Development Bank (ADB) fact-finding mission visited Nauru from 24 March to 1 April 2005 and reached an understanding with the Government on the impact, outcome, outputs, implementation arrangements, cost, financing arrangements, and terms of reference for the TA.¹ The design and monitoring framework is presented in Appendix 1.

II. ISSUES

2. The economy of Nauru has been deteriorating since the late 1980s as the country's single export commodity, phosphate, experienced falling export prices and lower production levels. During the last decade, the economy has deteriorated to a situation of economic crisis because of mismanagement of public funds. A complete collapse of the economy is being averted by activities associated with Nauru's agreement with Australia to host asylum seekers and by international aid. Gross national per capita income is estimated to have dropped from US\$2,000 in 2004 to about US\$500² in 2005.

3. A new and reformist Government was elected in October 2004 with a far greater majority than previous governments.³ A politically stable environment is required for sustaining needed but painful reforms that will affect all economic activity in Nauru. The new Government has inherited an economy in deep crisis together with an unaffordable and severely mismanaged public sector and a considerable public debt. The public sector, including the SOEs, is too large and inefficient to sustain services to the population of about 12,000 people. The Government has embarked on a process to reduce fiscal expenditure to within the means of the economic situation in Nauru. Salaries alone make up more than 50% of expenditure. The main immediate challenge facing the Government is the adverse impacts on the families of employees and the effects on economic activity that will result from rightsizing the overstuffed public sector.

4. Nauru's economy is dominated by 12 SOEs, which together employ about 2,000 people. The Nauru Phosphate Corporation (NPC) is the largest employer with about 1,500 staff. Rightsizing the SOEs will be associated with adverse social impacts as most households in Nauru are dependent on public sector wages with few options for alternative income sources. The management of the SOEs is weak and daily operations are subject to severe political interference. The Government is reviewing the highly politicized appointment process of the boards of directors of SOEs.

5. Most of the SOEs have commercial operations, while a few are structured as noncommercial statutory corporations or trusts. Maintenance of capital equipment is nearly nonexistent except from ad hoc emergency repairs. The account status of most of the SOEs is deplorable. The boards have never been made accountable for performance. With a few exceptions, financial statements have not been produced for almost a decade. Most of the SOEs are incurring operating losses and their suspected net asset position has been negative

¹ The TA first appeared in *ADB Business Opportunities* on 11 April 2005.

² ADB staff estimates based on public sector salaries, employment, economic activity, and household size.

³ The new Government has the confidence of having 16 out of 18 parliamentary seats.

for years. Because of complexities of cross-borrowing and lending, it is difficult to assess the net financial position. The capacity of the Government to reconstruct the accounts of the SOEs is also constrained, with only one qualified accountant remaining in the country.

6. The Government has identified the restructuring of NPC as an urgent priority in the reform process. NPC's main operations include mining, power, water, and port activities. The current size and structure of NPC, inherited from the era of phosphate mining, are unsustainable. The heavily oversized labor force lack motivation, particularly since they have not been paid in over 6 months. Management sees its primary role in phosphate mining with little incentive to provide water and power utility services. The reform of NPC will need to start with an understanding of its financial position, including assets and liabilities, and the state of its current infrastructure. The most recent independent audit of NPC was conducted in 2001, which raised concerns over receivables, doubtful debts, and evaluation of assets. The audit was unable to express an opinion on whether the accounts were prepared in accordance with international accounting principles.

7. The poor quality of electricity and water services in Nauru is of concern to the Government. Over the last 18 months, about A\$16 million in assistance from the Australian Agency for International Development (AusAID) has been allocated to the power sector. Despite disbursements of about A\$8 million for fuel, water shortages are frequent and electricity services are often only provided for a few hours a day. This situation is largely caused by poor management, inadequate maintenance, and low revenue collection. The largest defaulters include government agencies and SOEs. The situation is made worse by a practice of allowing public sector employees to pay electricity and water bills with Bank of Nauru checks to offset overdue public sector salaries. This has resulted in NPC being unable to raise the cash needed to meet fuel expenses.

8. Given the size of the economy of Nauru and the history of poor governance, potential private investors are likely to view the country as high risk. Options for privatizing water and electricity services may be meager, short-term, and require high returns to cover risk. The country also lacks the capacity to regulate and monitor a private sector monopoly. The culture of nonpayment of electricity bills is an additional risk for private sector investors. But it is evident that Nauru lacks the capacity to ensure the provision of water and electricity services to the people of Nauru and that private sector participation in the management of the utility is essential.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

9. The TA will help the Government in the restructuring of NPC by advising on viable institutional, technical, and financial options for providing water and electricity services to the people of Nauru. The TA will: (i) provide the Government with options for public-private sector participation for a reformed and independent water and power utility to improve performance, (ii) examine a transparent and explicit subsidy mechanism, (iii) provide a time-bound plan for phasing out subsidies over time, and (iv) provide technical options to address the low revenue collection. It is expected that the reform of NPC and private sector participation in the independent water and power utility will provide an example for restructuring the other SOEs with commercial operations.

B. Methodology and Key Activities

10. The TA will consist of two phases. The first phase will include a diagnostic of the activities and business structure of NPC, including an assessment of its performance. The outputs of the first phase will include: (i) statements of NPC's financial position, including assets and liabilities and the current state of its infrastructure; (ii) assessment of NPC's business procedures and practices and reporting arrangements to the Government; and (iii) assessment of management and staff capacity and skills. On the basis of the outputs of the first phase, the TA will recommend appropriate restructuring of NPC's businesses.

11. The second phase will focus on the operations of water and electricity services for Nauru. The TA will assess the viable institutional, technical, and financial options for private sector participation in the delivery of water and electricity services. This will include options for private sector management of the utility operations or a joint venture with the private sector. The TA will also examine contractual arrangements needed to manage risk, service obligations, and tariffs for each of the proposed options. The TA will also advise the Government on steps to be taken to embark on an international bidding procedure and contractual arrangements, including options for bidding for least-cost subsidies needed to regulate tariffs and service obligations. The outputs of the second phase will include: (i) recommendations for least-cost investment appropriate to serve unconstrained demand for water and power in Nauru; (ii) assessment of staffing and skill requirements for an independent water and power utility; (iii) preparation of a financial management model and projections; (iv) assessment of options for private sector participation; and (v) assessment of a transparent subsidy mechanism and subsidy requirements, including time-bound plans for the phasing-out of subsidies and funding arrangements. The second phase will also examine options such as prepay meters to eliminate the risk of nonpayment of electricity bills.

12. The TA will also help the Government in preparing a strategy for public consultation for disseminating information of the independent water and power utility, including tariffs and revenue collection. Implementing a public dissemination strategy is needed to address the culture of nonpayment of electricity bills.

C. Cost and Financing

13. The total cost of the TA is estimated at US\$470,000 equivalent, comprising US\$366,000 in foreign exchange and US\$104,000 equivalent in local currency. The Government has requested ADB to finance US\$375,000, comprising the entire foreign exchange cost and a portion of the local currency cost amounting to US\$9,000 equivalent, to be financed on a grant basis from the Government of Australia and administered by ADB. The Government will finance the remaining US\$95,000 equivalent of local currency costs through in-kind contributions of the executing and implementing agencies. Government counterpart funds will cover costs associated with office accommodation and facilities, local communication and transport, and counterpart staff. The detailed cost estimates and financing plan are in Appendix 2.

D. Implementation Arrangements

14. The Ministry of Finance (MOF) will be the Executing Agency and has assigned NPC as the implementing agency. NPC has agreed to assign counterpart staff in accounting, and in power and water systems planning. In order for NPC to be able to provide adequate finance and accounting counterparts, the Government and NPC have agreed to reengage the former accountant of NPC by 1 July 2005 and assign him as a counterpart for the financial

management specialist. MOF and the management of NPC will liaise closely with the consultants, make available relevant information, and facilitate the collection of financial and technical data needed for the implementation of the TA.

15. A firm will be engaged to provide about 9.5 person-months of international consulting services. The team of international consultants will consist of an SOE restructuring specialist (team leader, 4 person-months), a financial management specialist (3.5 person-months), and a power system planner and engineer (2 person-months). The firm will be engaged by ADB in accordance with the *Guidelines on the Use of Consultants*. The firm will be recruited using quality- and cost-based selection procedures; biodata technical proposals will be requested. The outline terms of reference for the consultants are in Appendix 3.

16. The TA will be implemented with intermittent consultancy services over a 7-month period, commencing in August 2005 with expected completion in March 2006. Implementation of the TA will be monitored by ADB TA review missions and regular communications with MOF and the team of international consultants. Reporting arrangements will include submission of: (i) an inception report within 4 weeks of commencement of services; (ii) an interim report within 2 months of the fielding of the consultants, which will be discussed during a tripartite meeting with the Government and ADB; and (iii) a draft final report to be discussed during a second tripartite meeting with the Government and ADB. The final report, incorporating the comments of the Government and ADB, will be submitted within 4 weeks of the second tripartite meeting.

IV. THE PRESIDENT'S DECISION

17. The President, acting under the authority delegated by the Board, has approved ADB administering technical assistance not exceeding the equivalent of US\$375,000 to the Government of Nauru to be financed on a grant basis by the Government of Australia for the Reform of the Nauru Phosphate Corporation, and hereby reports this action to the Board.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
Impact Improved electricity and water services to the people of Nauru	Reduced load shedding Increased water production	Utility records and data on load shedding and sales	Assumption <ul style="list-style-type: none"> • Sustained Government commitment to reforms
Outcome A reformed and independent water and power utility with transparent subsidy mechanism	Adequate financing of water and power utilities	Government decision Government budget and policy documents	Assumptions <ul style="list-style-type: none"> • Private sector participation • Government commitment to transparency
Outputs Phase 1 1. Financial position of NPC 2. NPC's business procedures and practices and reporting arrangements 3. Management and staff capacity assessment Phase 2 1. Private sector participation in water and power services 2. Contractual arrangements for private sector participation 3. Adequate and appropriate least-cost investment 4. Staffing and skill requirements for the utility	Improved and updated NPC accounts Improved business procedures and reporting arrangements to the Government Review of management and staff capacity and recommendations Improved management and independence of the utility operations International bidding and contract agreement Financial projections Demand forecast Enhanced technical performance	Consultant's reports Government reports on NPC consultant's report NPC staff records and Government reports Government and utility reports	Assumptions <ul style="list-style-type: none"> • Reengagement of NPC's former accountant • Government ceases to interfere in daily operations of NPC • Management capacity <ul style="list-style-type: none"> • Sustained Government commitment to reforms and to conducting public consultations, and noninterference in daily operations • Government decision on policy reform option • Availability of investment funds through Government allocations and sustained external assistance to the power sector

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p>5. Financial projections for the utility</p> <p>6. Design of a transparent subsidy mechanism</p> <p>7. Time-bound plan for phasing of subsidies</p> <p>8. Reduced risk of nonpayment of electricity bills</p> <p>9. Public dissemination</p>	<p>Financial management model</p> <p>Fiscal subsidy allocation</p> <p>Fiscal budget and financial projections</p> <p>Improved revenue collection</p>		<ul style="list-style-type: none"> • Training and skills development—sustained external assistance • Government affordability of subsidies and sustained external assistance to the power sector
<p>Activities with Milestones</p> <p>Phase 1—NPC operations</p> <p>1.1 Diagnostic of the activities and business structure of NPC</p> <p>1.2 Assessment of NPC’s financial position</p> <p>1.3 Assessment of staff and management capacity</p> <p>1.4 Recommendations of restructuring of NPC</p> <p>1.5 Interim report and tripartite meeting</p> <p>Phase 2—Water and power utility operations</p> <p>2.1 Assessment of least-cost investment requirements</p> <p>2.2 Assessment of staffing and skills requirements</p> <p>2.3 Proposed models for private sector participation</p> <p>2.4 Contractual arrangements and procedures for international bidding</p> <p>2.5 Preparation of financial management model and financial projections</p> <p>2.6 Subsidy assessment, including subsidy mechanism and time-bound plan for phasing out subsidies</p> <p>2.7 Assessment of prepay meters or other means of enhancing revenue collection</p> <p>2.8 Public dissemination strategy and implementation</p> <p>2.9 Draft final report and tripartite meeting</p> <p>2.10 Final report</p>			<p>Inputs</p> <ul style="list-style-type: none"> • ADB • Government • Consultants • Australian financial team • AusAID • NPC

ADB = Asian Development Bank, AusAID = Australian Agency for International Development, NPC = Nauru Phosphate Corporation.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Government of Australia Financing^a			
1. Consultants			
a. Remuneration and Per Diem of Consultants	308.0	0.0	308.0
b. Air Travel	21.0	0.0	21.0
c. Reports and Communications	10.0	5.0	15.0
2. Miscellaneous Administration and Support Costs	2.0	2.0	4.0
3. Representative for Contract Negotiations	7.0	0.0	7.0
4. Contingencies	18.0	2.0	20.0
Subtotal (A)	366.0	9.0	375.0
B. Government of Nauru Financing			
1. Office Accommodation and Transport	0.0	30.0	30.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	65.0	65.0
Subtotal (B)	0.0	95.0	95.0
Total	366.0	104.0	470.0

^a Administered by the Asian Development Bank.
Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. International Consultants (total 9.5 person-months)

1. State-Owned Enterprise (SOE) Restructuring Specialist and Team Leader (international, 4.0 person-months)

1. The SOE restructuring specialist will have a master's degree in business or public administration, law or related fields, and at least 15 years work experience in areas related to management, restructuring and privatization processes of SOEs and in international bidding. The consultant must have experience in working in the power sector in developing Asian countries. The consultant will have significant team leader experience and excellent communication skills. The consultant will do the following:

- (i) Undertake responsibility for team coordination to ensure consistency and quality of the different aspects of the work, appropriate sequencing of consultancy inputs, reporting and dissemination arrangements, and liaising with ADB, the Australian Agency for International Development (AusAID), Ministry of Finance (MOF), and Nauru Phosphate Corporation (NPC), and other stakeholders as needed.
- (ii) Arrange and conduct stakeholder workshops and arrange presentations for tripartite meetings as needed.

2. Phase 1. Under phase 1, the consultant will do the following:

- (i) Provide a diagnostic of NPC's activities, size and business structure and business procedures, including a performance assessment and identification of institutional, managerial, and operational constraints covering all aspects of NPC. The diagnostic will include benchmarking performance, practices, and procedures against best practice.
- (ii) Recommend an organizational structure of NPC and identify the requirements, costs, and benefits for unbundling to rationalize operations in water and electricity services. The recommendations will include arrangements for fuel purchase. Identify legal, financial, or institutional barriers that may be relevant for the reform of NPC.
- (iii) Prepare a plan for the reform process of NPC, including a time-bound implementation schedule and details on the steps to be taken by the Government of Nauru and NPC.
- (iv) Prepare an impact assessment matrix clearly identifying the different stakeholders and their social and economic costs and benefits of the reform of NPC.
- (v) On the basis of billing and revenue collection practices, prepare a plan to improve revenue, including the design of a public communication strategy.
- (vi) Assist the Government in preparing and undertaking public and stakeholder dissemination on the reform process of NPC, particularly on tariff increases and payment of bills.

3. Phase 2. Under phase 2, the consultant will do the following:

- (i) Provide an assessment of the affordability to pay for water and electricity services for all consumer categories. Recommend arrangements, including the

possibility of prepay meters, to address revenue collection arrangements for the different consumer categories, including government agencies, and industrial, commercial, and residential consumers.

- (ii) Recommend arrangements for corporatization and private sector participation (PSP) in the unbundled water and electricity utility that would improve the independence and efficiency of the operations. Evaluate the institutional and financial viability, the benefits and costs along with identified constraints for at least three best-practice options suitable for Nauru.
- (iii) In line with the recommended PSP options, prepare contractual arrangements that address all identified risks, including a possible trade-off between a need to provide subsidies and incentives for private providers to collect revenues.
- (iv) Prepare internal good governance business procedures and shareholder reporting arrangements for the unbundled water and electricity utility.
- (v) Assess the capacity of the Government and NPC to undertake the reform and identify advisory services that may be needed in implementing the reform process. This will include information on contractual arrangements under a PSP arrangement. If advisory services are needed, prepare the terms of reference and time inputs.
- (vi) Propose a transparent subsidy mechanism for water and electricity services and prepare a time-bound phased implementation plan, including costing of subsidies.

2. Financial Management Specialist/Auditor (international, 3.5 person-months)

4. The financial management specialist will have a professional accountancy designation, and a background in auditing. The consultants will have at least 15 years experience in accounting, financial modeling, and restructuring processes of SOEs and the private sector. Experience in the power sector in developing Asian countries is highly desirable.

5. **Phase 1.** Under phase 1, the consultant will do the following:

- (i) Undertake an evaluation of NPC's financial assets, including current state, value and expected lifetime, and liabilities. Prepare a proposal for separating assets and liabilities by the proposed profit centers of NPC.
- (ii) Review the financial statements of NPC and prepare a statement of accounts of the financial position, performance, and cash flows of NPC in accordance with international accounting and financial reporting standards. The financial assessment of NPC will take into account the proposed unbundled structure of NPC.
- (iii) Assess NPC's financial management capabilities and the capacity to comply with reporting requirements to Parliament and the Public Accounts Committee. Recommend measures and procedures to strengthen the financial management of NPC and enhance shareholder insight and accountability along with a time-bound implementation plan.
- (iv) Identify key nonpaying consumers and assist the team leader in the design of a plan to improve revenue collection.

6. **Phase 2.** Under phase 2, the consultant will do the following:

- (i) Prepare financial projections, including income statement, balance sheet, and cash flow by profit center using appropriate software and prepare projections for

the financial performance for the water and electricity utility, taking into account investment requirements, for each of the proposed PSP options.

- (ii) Prepare guidelines for appropriate financial reporting to shareholders.
- (iii) Calculate average cost recovery tariffs and propose tariff structures that would ensure a reasonable rate of return. Prepare a proposal for a transparent subsidy mechanism and a plan for phasing-out of subsidies over time.

3. Power System Planner and Engineer (international, 2.0 person-months)

7. The power system planner will have an advanced degree in electrical or mechanical engineering or power system planning. The consultants will have at least 10 years experience in working in the power sector and have experience in the water sector in developing countries. Experience in working in the Pacific countries or other small island economies is highly desirable.

8. **Phase 1.** Under phase 1, the consultant will prepare an evaluation of the technical and economic lifetime of assets for water and electricity supply, including desalination, generation and distribution, and propose a separation of assets and staff between the phosphate mining and utility services activities of NPC.

9. **Phase 2.** Under phase 2, the consultant will do the following:

- (i) Prepare base-, low-, and high-demand forecast scenarios for water and electricity services, taking into account that phosphate mining activities may resume, for an appropriate technical and economic planning horizon.
- (ii) Assess the capacity and appropriateness of water desalination and electricity generation and distribution systems. Prepare a least-cost development plan for the water and electricity supply systems for meeting forecast demands, taking into account fuel costs, and operation and maintenance costs.
- (iii) Examine arrangements for fuel purchase and propose institutional arrangements for the proposed unbundled structure of NPC that would improve planning, cost efficiency, and transparency in fuel purchase and usage.
- (iv) Provide an assessment of the technical staff in terms of size of the labor force and skill levels. Assess skill requirements to maintain and sustain the water and electricity utility and prepare a skills development program along with a time-bound implementation schedule and cost estimates.
- (v) Prepare a feasibility study for implementing prepay meters for different consumer categories, including costs and benefits.

B. Reporting Requirements

10. Within 4 weeks of commencement of services, the team leader will submit an inception report. Brief mission reports will be submitted after each consultant field visit. An interim report will be submitted within 2 months of commencement of services to be discussed during a tripartite meeting with the Government and ADB. The draft final report will be discussed during a second tripartite meeting. The final report, incorporating the comments of the Government and ADB, will be submitted within 4 weeks of the second tripartite meeting, in hard copy and in electronic formats. The consultants will make available all data, calculations, and spreadsheets.