



Technical Assistance Report

Project Number: 43014
Policy and Advisory Technical Assistance (PATA)
April 2009

Kingdom of Tonga: Reforming Public Enterprises

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 April 2009)

Currency Unit	–	pa'anga (T\$)
T\$1.00	=	\$0.460350
\$1.00	=	T\$2.172260

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
MPEI	–	Ministry of Public Enterprises and Information
PSD	–	private sector development
TA	–	technical assistance

TECHNICAL ASSISTANCE CLASSIFICATION

Type	–	Policy and advisory technical assistance (PATA)
Targeting Classification	–	General intervention
Sector (subsector)	–	Public sector management (economic and public affairs management)
Themes (subthemes)	–	Private sector development (public–private partnerships, privatization), economic growth (promoting economic efficiency and enabling business environment), governance (economic and financial governance)
Location impact	–	National

NOTES

- (i) The financial year (FY) of the Government and its agencies ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2009 ends on 30 June 2009.
- (ii) In this report, "\$" refers to US dollars unless otherwise stated.

Vice-President	C. Lawrence Greenwood, Jr., Operations 2
Director General	S. H. Rahman, Pacific Department (PARD)
Director	E. Zhukov, Pacific Liaison and Coordination Office, PARD
Team leader	W. Wicklein, Senior Private Sector Development Specialist, PARD

In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.

I. INTRODUCTION

1. The Asian Development Bank (ADB) has supported Tonga's comprehensive public enterprise reform (rationalization) process since 2002, when the country passed the Public Enterprises Act.¹ A series of technical assistance (TA)² projects helped the Government strengthen the corporate governance of public enterprises, establish a financial performance monitoring framework, train directors and senior officials on requirements of the Public Enterprises Act, and develop its capacity to monitor and rationalize the public enterprise portfolio.

2. In 2006, the Prime Minister made public enterprise reform a central tenet of his economic growth plan, and created the Ministry of Public Enterprises and Information (MPEI) as a specialist public enterprise monitoring agency to accelerate the reform. The most recent phase (phase III) of the rationalization process, completed in late 2008, focused on five public enterprises, and executed the first privatization of a Tongan public enterprise with the sale of the Government's majority shareholding in Leiola duty free stores. Another enterprise has been liquidated through an asset sales process, and three additional enterprises are at various stages of the approved rationalization process. Drawing from the success and momentum created from this process, the Government has reaffirmed its strong reform commitment and requested that ADB provide further TA to finalize the ongoing transactions and to prepare rationalization plans for most of the remaining public enterprises in the portfolio.

3. This TA³ directly supports implementation of the Government's Strategic Development Plan Eight 2006/07–2008/09 by promoting private sector-led growth through corporatization of selected government commercial activities, privatization of selected public enterprises, and strengthened corporate governance in the public enterprise sector. It is in line with ADB's 2007–2012 country partnership strategy for Tonga, particularly the focus areas of private sector development (PSD) and fiscal management.⁴ It is consistent with ADB's Pacific Strategy.⁵ The TA design and monitoring framework is in Appendix 1.

4. The TA is part of a new partnership between ADB and Tonga in support of private sector-led economic growth. ADB's 2008 private sector assessment⁶ for Tonga helped establish a comprehensive program of PSD reforms, which are being implemented. The program includes the rationalization of public enterprises, as supported under this TA, as well as outsourcing road maintenance activities, strengthening the legal business environment, and enhancing access to finance, with support from ADB's Pacific PSD initiative.⁷

¹ ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Tonga for the Economic and Public Sector Reform Program*. Manila (Loan 1904-TON[SF], for SDR8,020,000, approved on 28 May).

² ADB. 2003. *Technical Assistance to the Kingdom of Tonga for the Rationalization of Public Enterprises*. Manila (TA 4111-TON, for \$515,000, approved on 9 May); ADB. 2004. *Technical Assistance to the Kingdom of Tonga for Public Enterprise Reform, Phase II*. Manila (TA 4514-TON, for \$150,000, approved on 20 December); and ADB. 2006. *Technical Assistance to the Kingdom of Tonga for Rationalization of Public Enterprises, Phase III*. Manila (TA 4899-TON, for \$400,000, approved on 18 December).

³ The TA first appeared in the business opportunities section of ADB's website on 19 February 2009.

⁴ ADB. 2007. *Country Partnership Strategy 2007–2012: Tonga*. Manila.

⁵ ADB. 2004. *Responding to the Priorities of the Poor: A Pacific Strategy for the Asian Development Bank, 2005 – 2009*. Manila.

⁶ ADB. 2008. *Transforming Tonga: A Private Sector Assessment*. Sydney and Manila.

⁷ ADB. 2006. *Technical Assistance for the Private Sector Development Initiative*. Manila (TA 6353-REG, for \$8.7 million and cofinanced by the Australian Agency for International Development with \$7.6 million, approved on 21 November).

II. ISSUES

5. Tonga's public enterprise reform process has only just begun. Its public enterprise sector still inhibits PSD and depresses economic growth. Many public enterprises compete against the private sector, and do so with the advantage of subsidized capital and—in many cases—preferred access to government contracts. This practice serves to crowd out the private sector, thereby reducing opportunities for private investment and innovation. The low productivity of public enterprises also weakens the economy's overall performance. Public enterprises control 14%–22% of total fixed assets within the economy, yet contribute just over 6% to gross domestic product (GDP).⁸ Each \$1 invested in public enterprises contributes just \$0.26 to GDP, compared to \$0.84 for each \$1 invested in the private sector. Tonga's public enterprises currently achieve an overall return on average equity of 3.9% (see Appendix 2). This is well below the 10% target return on equity set by the Government for the public enterprise portfolio, and far less than the rates of return expected in the private sector.

6. The difference between the opportunity costs of capital, which conservatively is set by the Government's target return, and the returns actually achieved by public enterprises represent a real loss of economic value, which compounds each year. The economic value destroyed by the public enterprise portfolio in Tonga over FY2002–FY2006 equals around half of the Government's budget spent on health and education for the same period. Rationalization of public enterprises will not only reduce the economic cost associated with these underperforming assets but will also free up capital to invest in more productive sectors of the economy, including the vital social sectors.

7. Creating more opportunities for private investment and reducing the economic strain represented by public enterprises will require (i) an accelerated effort to rationalize the remaining enterprises in the Government's portfolio, which may include the restructuring and divestiture of activities that can be conducted more efficiently by the private sector; and (ii) continued capacity development in corporate governance to strengthen public enterprise directors' ability to serve as effective stewards of their public enterprises, strategic and financial analysis of public enterprises, and public–private partnerships for MPEI⁹ and other government agencies.

8. International experience suggests that the key to successful public enterprise reform is to infuse public enterprises with private sector discipline and competitive market pressures. Lessons learned in Tonga and comparable countries in the region include: (i) political commitment is vital to successful reform; (ii) continued financing of poorly performing public enterprises does not restore their profitability; (iii) the private sector has the capacity to invest in public enterprises and to deliver community service obligations; and (iv) reform prescriptions should be avoided, and innovation and flexibility should be emphasized in the reform response to enterprise-specific issues and situations. Reform options may involve measures such as privatization, public–private partnerships, restructuring, liquidation, and community service obligations.

9. Political commitment to public enterprise reform is high in Tonga. The Government has demonstrated its reform commitment through results achieved in the course of the reform

⁸ ADB. 2009. *Finding Balance: Making State-Owned Enterprises Work in Fiji Islands, Samoa, and Tonga*. Sydney and Manila. Figures are for 2005.

⁹ MPEI includes 14 staff members, including the director, the deputy secretary, five financial analysts, and administration and support personnel. An additional analyst is being recruited. As a relatively new government ministry, MPEI is developing its capacity with the support of the TA and independently.

process, including a first privatization and several ongoing pre-privatization initiatives such as privatization tenders, liquidations, and the progressive adoption of a new policy to phase out all government ministers and public servants from public enterprise boards. The TA, as proposed by the Government, will cover the rationalization of a relatively large number of public enterprises, including three public enterprises currently reformed and at least five larger infrastructure-related public enterprises.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

10. The overall impact of the TA is increased private sector investment to fuel growth in Tonga's economy. Reducing the size and breadth of the public enterprise sector will have a direct impact on private investment, as opportunities for service delivery dominated by public enterprises will be opened up to the private sector, and a more level playing field established for private competitors of public enterprises.

11. The expected outcome is reduced fiscal exposure to public enterprises. This will be achieved through rationalization of the public enterprise portfolio, creating opportunities for private ownership of public enterprises and for private involvement in the operation of public enterprises through contracting out and public-private partnerships. The rationalization of the public enterprise portfolio is also expected to free up cash through divestment of public enterprises or sale of assets and by improving the performance of those enterprises remaining under public ownership. Moreover, the TA will strengthen the legal and governance framework of Tonga's public enterprise sector and will build capacity within MPEI to monitor the Government's investments in public enterprises.

B. Methodology and Key Activities

12. The TA will assist the Government with the rationalization of selected public enterprises that have been identified by MPEI. Specifically, the TA will help (i) complete the ongoing rationalization strategy approved by the Government for three public enterprises; (ii) determine the rationalization strategy for at least five additional public enterprises; (iii) prepare a rationalization plan for at least five public enterprises; (iv) provide technical, financial, and regulatory advice for the implementation of the approved strategy and implementation plan for at least five public enterprises; (v) provide technical support for the due diligence process and the valuation process in the case of privatization or asset sale; (vi) develop MPEI capacity through on-the-job training; (vii) develop capacity of MPEI and public enterprise boards and management through training in governance and financial analysis; and (viii) develop a director evaluation process.

13. Based in Tonga for most of the TA duration, a small team of national and international experts will lead the rationalization process and develop capacity for MPEI staff in technical, management, and regulatory areas as well as for public enterprise boards and management in corporate governance and financial analysis. While it is not anticipated that the public enterprise reform agenda will be completed under this TA, the finalization of several rationalizations is expected. In some cases, the Government may determine, in consultation with TA experts and ADB, that progress cannot be made for reasons beyond the control of the TA. Progress and issues will be closely monitored.

C. Cost and Financing

14. The total cost of the TA is estimated at the equivalent of \$625,000. Of this, \$500,000 will be financed on a grant basis by ADB's TA funding program (TA Special Fund IV). The Government will finance the equivalent of \$125,000 in kind through the provision of counterpart staff, office accommodations, and local communication. Details of the cost estimates and financing plan are in Appendix 3.

D. Implementation Arrangements

15. MPEI will be the Executing Agency for the TA and ensure that TA activities are closely coordinated with central agencies such as the Ministry of Finance and relevant sector ministries, as well as the public enterprises.

16. The TA will be implemented over a period of 15 months, from May 2009 to July 2010. A small team of international experts will be engaged on an individual basis, including a public enterprise reform expert (team leader) and a financial analyst. The international team will be supported by a local legal expert. The consultants will be selected and engaged by ADB in accordance with its *Guidelines on the Use of Consultants* (2007, as amended from time to time). The TA will require about 19 person-months of consulting services, comprising about 16 person-months of international and about 5 person-months of national consultants, to carry out the activities as defined in the terms of reference (Appendix 4). The experts will be supplemented by ADB's regional TA resources, including the Pacific PSD Initiative, as required to intensify reform activities. The proceeds of the TA will be disbursed in line with ADB's *Technical Assistance Disbursement Handbook*.¹⁰

17. The team leader will produce a concise inception report outlining the work program and milestones for the duration of the TA, and a final report summarizing the achievements, issues, lessons learned, and next steps. Throughout the TA, the team leader will submit (by e-mail) brief monthly progress reports summarizing TA activities, progress, issues, and constraints. Team members will produce inputs (reports) on their respective activities for the team leader's progress and final reports. The team leader's final report will be submitted in draft form at least 5 weeks prior to the end of the assignment, and the final report within 2 weeks of receipt of comments by the Government and ADB.

IV. THE PRESIDENT'S DECISION

18. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$500,000 on a grant basis to the Government of Tonga for Reforming Public Enterprises, and hereby reports this action to the Board.

¹⁰ ADB. 2008. *Technical Assistance Disbursement Handbook*. Manila.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and/or Indicators	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
Impact Increased private sector participation in economy	Increased private sector share of gross domestic product and formal employment	Government statistics and economic reports	Assumption Political risk factors do not affect government commitment or private sector investor confidence.
Outcome Reduced fiscal exposure to public enterprises	Reduced size of public investment in public enterprises Improved rates of return for the targeted enterprises with demonstrable progress toward meeting or exceeding the 10% return objective	Government reports (Ministry of Public Enterprises and Information)	Assumption Current levels of government commitment to the reforms are maintained.
Outputs 1. Completion of rationalization of three public enterprises from previous TA 2. Rationalization of at least five additional public enterprises 3. Training courses in public-private partnerships, financial management, and director development 4. Development and implementation of director performance evaluation system	Rationalizations achieved Rationalizations achieved Effective training courses delivered and positively evaluated by participants, and new skills and attitudes applied in the workplace Effective director performance system established and applied on regular basis	Government reports, TA reports, training course surveys, board surveys, ADB review missions	Assumptions Current levels of government commitment to the reforms are maintained. Management and boards of targeted public enterprises cooperate with the Government's reform efforts as supported by the TA.

Activities with Milestones	Inputs
<ul style="list-style-type: none"> 1.1 Complete implementation of recommended strategies for three ongoing rationalizations of public enterprises (October 2009) 1.2 Review Public Enterprises Act, and submit recommendation for any amendment to the Cabinet (November 2009) 2.1 Complete situation assessment of at least five additional public enterprises and development of respective rationalization strategy (from August 2009 through to mid-2010) 2.2 Submit rationalization recommendations to the Cabinet (from August 2009 through to mid-2010) 2.3 Implement approved rationalization strategies (by end of TA, except for those elements of strategies recommended for later execution) 3.1 Complete financial training (including valuation training) (November 2009) 3.2 Complete public–private partnership training (November 2009) 3.3 Complete director development training (November 2009) 4.1 Undertake governance consultations, and establish director performance review process (August 2009) 4.2 Undertake director performance assessment (September 2009) 4.3 Develop ongoing training and development programs for directors (August 2010) 	<p>ADB TASF-IV grant: \$500,000</p> <p>Government (including public enterprises) in-kind contributions equivalent to \$125,000</p> <p>Consultants</p> <p>Other stakeholders, including private sector</p>

ADB = Asian Development Bank; TA = technical assistance.

KEY PERFORMANCE INDICATORS OF PUBLIC ENTERPRISES IN TONGA
(T\$'000, latest data as of March 2009)^a

Item	% State-Owned	Return on Average Equity	Total Revenue	Net Profit After Tax	Total Assets	Total Liabilities	Liabilities/Assets	Cash Ratio
Tonga Communications Corporation	100	13.4%	26,473	5,680	54,917	10,197	18.6%	147%
Tonga Broadcasting Commission	100	5.8%	2,823	140	3,834	1,350	35.2%	3%
Tonga Water Board	100	(3.6%)	3,822	(697)	20,280	1,156	5.7%	8%
Ports Authority Tonga	100	3.3%	6,583	462	21,964	7,504	34.1%	19%
Tonga Timber Ltd	100	2.8%	2,280	167	6,975	1,017	14.6%	0%
Tonga Print Ltd	100	2.2%	800	29	1,549	190	12.3%	195%
Tonga Market Ltd	100	0.6%	707	10	4,448	2,965	66.6%	13,789%
Tonga Investments Ltd ^b	100	0.3%	4,834	19	6,433	1,094	17.0%	29%
Tonga Machinery Pool ^b	100	(18.4%)	1,019	(83)	504	98	19.4%	0%
Shipping Corporation of Polynesia Ltd	100	(60%)	3,337	(251)	2,083	2,438	117.0%	13%
Tonga Development Bank	100	6.2%	9,283	1,517	65,240	40,351	61.8%	112%
Tonga Airports Limited	100	(1.3%)	6,031	(611)	47,252	809	1.7%	129%
Waste Authority Ltd	100	13.5%	1,463	591	4,962	297	6.0%	16%
International Dateline Hotel Ltd ^c	100	(1.7%)	152	(94)	8,094	2,708	33.5%	–

() = negative; – = not available.

^a Tonga Power Limited is not included in the table as it was repurchased by the Government in late 2008. *Tonga Post* is not included because it was corporatized only in July 2008.

^b Tonga Investments Ltd and Tonga Machinery Pool are in liquidation.

^c International Dateline Hotel Ltd is a holding company, and its results do not reflect the performance of Janfull International Dateline Hotel Limited, of which it is a 49% shareholder.

Source: Ministry of Public Enterprise and Information, Government of Tonga.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Total Cost
A. Asian Development Bank Financing^a	
1. Consultants	
a. Remuneration and Per Diem	
i. International Consultants	400.0
ii. National Consultants	30.0
b. International and Local Travel	15.0
c. Reports and Communications	1.0
2. Training, Seminars, and Conferences	3.0
3. Miscellaneous Administration and Support Costs	1.0
4. Contingencies	50.0
Subtotal (A)	500.0
B. Government Financing^b	
1. Office Accommodation and Transport	45.0
2. Remuneration and Per Diem of Counterpart Staff	55.0
3. Communication	5.0
4. Contingencies	20.0
Subtotal (B)	125.0
Total	625.0

^a Financed by the Asian Development Bank's technical assistance funding program (Technical Assistance Special Fund IV).

^b Financed by in-kind contributions by the Government of Tonga.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. A team of international and national consultants, led by an international public enterprise reform specialist, will assist the Ministry of Public Enterprises and Information (MPEI) in rationalizing the public enterprise portfolio to support the Government of Tonga in promoting private-sector led growth and reducing fiscal burdens associated with public enterprises.

A. International Public Enterprise Reform Specialist (team leader, 9 person-months total)

2. The consultant will coordinate various reform activities under the technical assistance (TA) project and be the principal adviser to the Government under the TA. The consultant will

- (i) Review the findings and recommendations of previous TAs provided to the Government in support of rationalizing public enterprises.
- (ii) Continue the necessary work to complete the rationalizations of three public enterprises (International Dateline Hotel Ltd, Shipping Corporation of Polynesia Ltd, and Tonga Timber Ltd,) from the previous reform phase.
- (iii) Lead the development of suitable rationalization strategies for designated public enterprises (Ports Authority Tonga, Tonga Airports Limited, Tonga Broadcasting Commission, Tonga Communications Corporation, Tonga Power Limited, Tonga Water Board, and Waste Authority Ltd), which will include assessments of the current situations of the enterprises and strategy options, based upon (a) detailed financial projections, sensitivity analyses, and, when appropriate, valuations; (b) considerations of legal, taxation, regulatory, labor, and other relevant issues; and (c) strategy recommendations, including where appropriate, recommendations to the Cabinet of Ministers.
- (iv) Manage the preparation of a full range of rationalization strategies that will be considered for each case, with the objective of recommending the strategy that best addresses the circumstances. Ensure that social safeguard considerations are taken into account in the government's decision making process. Potential strategies may entail privatization, public-private partnerships, financial or operational restructuring to improve performance, formalizing community service obligations, contracting out, and other rationalization measures.
- (v) As part of each strategy option, undertake, but not be limited to, (a) identification of critical business and regulatory issues to be addressed, (b) implementation of processes to enable change or to advance legislation to address such issues, (c) identification of an appropriate strategy to sell equity or to attract a partner, and (d) implementation of adequate processes to attract potential buyers or partners, including manage the sale or negotiation process.
- (vi) Actively support and participate in the implementation of approved rationalization strategies.
- (vii) Review the Public Enterprises Act, and make recommendations for reform. As required, propose amendments to the act for cabinet consideration.
- (viii) Through on-the-job training, and formal training in valuation and public-private partnerships, implement a training program to develop the skills and capacity of MPEI staff and other government officials, as required, to lead and implement the rationalization of public enterprises.
- (ix) Develop and implement a financial, strategy, and corporate governance training program for management and boards of all public enterprises.
- (x) Assist MPEI in conducting corporate governance consultations with the directors and company secretaries of the public enterprises.

- (xi) Assist MPEI in the design of an appropriate director performance review process.
- (xii) Assist MPEI, as needed, in preparing and conducting director performance reviews.

3. The consultant will have a degree in business administration, finance, or a similar field, and relevant experience in business finance and management. Skills should include corporate finance (including valuation) and restructuring, privatization and public-private partnerships, corporate governance, and training. The consultant will have at least 15 years of relevant work experience, and extensive knowledge and international experience in public enterprise reform, both in regard to policy reform and transactions. Previous relevant work experience in Tonga or the Pacific region is highly desirable. The consultant will be an excellent communicator and effective team leader.

B. International Financial Analyst (7 person months)

4. The consultant will support the team leader through financial analysis on portfolio and enterprise levels, as well as through financial restructuring and transaction-oriented financial engineering. In particular, the consultant will

- (i) Review the findings and recommendations of previous TA projects provided to the Government in support of rationalizing public enterprises, including past approaches to enterprise financial analysis and rationalization planning.
- (ii) Support the team leader in developing suitable rationalization strategies for five designated public enterprises, to include: (a) assessments of the current financial situations of the enterprises; (b) for the development of enterprise strategy options, conduct detailed financial projections, sensitivity analyses, and, when appropriate, valuations; and (c) assist in preparing strategy recommendations, including recommendations to the Cabinet of Ministers as appropriate.
- (iii) Conduct the financial analysis for the preparation of a full range of rationalization strategies that will be considered for each case. Potential strategies may entail privatization, public-private partnerships, financial or operational restructuring to improved performance, community service obligations, contracting out, and other rationalization measures.
- (iv) Actively support and participate, as necessary, in the implementation of approved rationalization strategies.
- (v) Help complete the rationalizations of three designated enterprises from the previous reform phase.
- (vi) Provide on-the-job training to MPEI and targeted enterprise staff, and participate in formal training in valuation and other finance-related modules.

5. The consultant will have a degree in accounting or finance with at least 10 years of practical experience in financial management and analysis. Relevant international project experience should include accounting and finance, comprising financial analysis and projections, discounted cash flow valuations, and public enterprise reform strategies. Relevant experience in Tonga or the Pacific region is desirable.

C. Legal Adviser (national, 5 person-months)

6. The legal adviser will support the international team in advising MPEI on legal issues arising from the TA, as well as in transactional matters. In particular, the consultant will

- (i) Review the findings and recommendations of previous TA projects provided to the Government in support of rationalizing public enterprises, including past approaches to enterprise financial analysis and rationalization planning.
- (ii) Support the team leader in developing suitable rationalization strategies for five designated public enterprises, with particular attention to the legal, statutory, and other government requirements that will impact the rationalization activities.
- (iii) Conduct the legal analysis for the preparation of a full range of rationalization strategies that will be considered for each case. Potential strategies may entail privatization, public-private partnerships, financial or operational restructuring to improved performance, community service obligations, contracting out, and other rationalization measures.
- (iv) As part of each strategy option, identify critical business, legal, and regulatory issues to be addressed, and help implement processes to enable change or to advance legislation to address such issues.
- (v) Help complete the rationalizations of three designated enterprises from the previous reform phase, as required.
- (vi) In consultation with the team leader, review the Public Enterprises Act, and make recommendations for reform. As required, propose amendments to the act for cabinet consideration.
- (vii) Provide on-the-job training to MPEI and targeted enterprise staff, and participate in the formal training in respect to the national legal and regulatory environment training modules.

7. The consultant will have a law degree and be a qualified lawyer practicing in Tonga with a thorough knowledge of the local legal, regulatory, and governmental structures, including the Companies Act, the Public Enterprises Act, and contract law. The consultant will have experience in commercial and transactional advice, government legal support, and public enterprise reform. The consultant will be an excellent communicator and be an effective team player in multidisciplinary and international teams.