DEBT SUSTAINABILITY

1. Palau's public debt is sustainable and fiscal vulnerabilities are contained. In FY2019, public debt was relatively low at the equivalent of 32.5% of GDP. However, the impact of coronavirus disease (COVID-19) is estimated to have raised government financing needs to $31.2 million (12.2% of gross domestic product) in fiscal year (FY) 2020 and to a projected $53.4 million (23.8%) in FY2021. To bridge the gap in FY2021 Republic of Palau has requested a concessional policy-based loan of $20 million from Asian Development Bank's (ADB) ordinary capital resources.[1] With new borrowings, including $20 million to support government's COVID-19 mitigation program, Palau's external debt increased to 45% of gross domestic product (GDP) in FY2020; and the Palau Public Utilities Corporation's (PPUC) contingent liabilities associated with power purchase agreements (PPA) (estimated for 20MW of solar power per year over 10 years) contribute as high as 24% of GDP, creating a combined exposure of 69% of GDP.[2] To strengthen its fiscal risk management in this area, the government has mandated the Palau Energy Administration (PEA) to monitor PPAs with independent power producers (IPP) reconciling terms with PPUC financial position and capacity.

2. The summary of contingent liabilities arising from PPUC, as compared to government debt is presented in Table 1. An overall summary of Palau fiscal and fiduciary indicators is presented in Table 2.

Table 1: Palau's Current Fiscal and Contingent Liabilities, 2020

Item	Public Debt	PPUC debt	PPUC Contingent liabilities
Total External Debt ($ million)	115.2	21.9[a]	38.0
Percentage of GDP	45%	9%	15%[b]

GDP = gross domestic product, PPUC = Palau Public Utilities Corporation.
[a] Long-term debt for PPUC. PPUC Audited Financials, 2019.
[b] Consultant's estimate. Power purchase agreement value assumes "Package A" from Palau Energy Administration RFP, (2019), which is a 20 gigawatt-hour(GWH)/year delivery. Under this development package, independent power producer would deliver up to 20 GWH of electricity during the first 10 years of operation at $0.19/kilowatt-hour. (20 X 10 X 0.19 X 10^6). GDP 2019 is 268.4. Source: Graduate School USA, EconMAP. 2020. *Palau: Fiscal Year 2019 Statistical Appendices.*
Source: Graduate School USA. 2019. *Palau FY 2018 Economic Brief*; Republic of Palau. 2020. "COVID-19 Presidential Borrowing Act of 2020; House Bill No. 10-131-14s.

Table 2: Fiscal and Fiduciary Indicators for Palau

	Actual				Estimate	Forecast		
Item	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**	**FY2020**	**FY2021**	**FY2022**
Projected GDP growth (ADB)						*(9.5%)*	*(12.8%)*	*2%*
GDP	281.5	297.1	282.2	277.8	268.4	242.9	211.8	216.0
CFA Trust Fund Balances	183.9	196.8	219.5	297.5	281.9	281.0	280.1	279.1
FISCAL INDICATORS	*Expressed in percentage of GDP**							
Government revenue	41.2	42.2	40	44.4	43.5	39.7	42.2	42.6
Of which is grants	15.5	16.6	13.2	17.8	17.0	17.0	17.0	17.0

[1] ADB. 2020. *Project Concept Paper: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 for Palau for Recovery through Improved Systems and Expenditure Support Program*. Manila.
[2] This figure does not count the quasi-fiscal risk embedded in the Civil Service Pension Plan, which is discussed below.

Item	Actual FY2015	FY2016	FY2017	FY2018	Estimate FY2019	Forecast FY2020	FY2021	FY2022
Primary Expenditure	35.4	37.5	34.3	37.2	42.2	50.9	65	37.9
Primary balance	5.8	4.7	5.7	7.2	1.3	(11.2)	(22.8)	4.7
Interest payments	0.6	0.9	0.9	0.9	0.9	1.0	1.0	0.8
Overall balance	5.2	3.8	4.8	6.3	0.4	(12.2)	(23.8)	3.9
Public Debt	27.3	31	32.4	33.5	32.5	46.4	66.9	58.1
PUBLIC DEBT				*Expressed in $ million*				
Public Debt[a]	64.4	79.3	85.3	91.2	87.2	118.2	150.0	125.5
Public enterprises	36.2	31.5	27.7	25.2	22.7	22.7	22.7	22.7
PPUC (long term debt)	7.98	8.34	5.69	17.21	21.86	21.86	21.86	21.86
PPA[b]						38.0	38.0	38.0

ADB = Asian Development Bank, CFA = Compact of Free Association, FY = fiscal year, GDP = gross domestic product, PPA = power purchase agreement, PPUC = Palau Public Utilities Corporation

[a] Projections for public debt based on ADB. 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Countercyclical Support Facility Loan Republic of Palau: Health Expenditure and Livelihoods Support Program*. Manila

[b] An additional PPA for up to 55megawatt may be initiated by FY25. This may mean an additional $66.5 million in guarantees. (35 X 10 X 0.19 X 10^6).

Sources: ADB, CFA Trust Fund Balances from International Monetary Fund, PITIVITI, and ADB Consultant.

A. Current Context

3. Palau’s fiscal situation is unique in that government revenues come largely from international grants (many linked to specific expenditures) and a limited tax base. It has maintained a strong fiscal position, though quasi-fiscal risk exposure is high.

4. A significant portion of government revenue comes from grants. From FY2014 to FY2018 all operating grants have averaged 26% of total revenues and 14% of GDP.[3] The most significant grants come from the Compact of Free Association (CFA) with the United States (US). Under the CFA Palau has received $13.15 million annually since FY2010, which is placed in the Compact Trust Fund, established in 1994.[4] The balance of the fund was $293 million in FY2018.[5] Palau has been drawing down the fund at a rate of $5 million each year through FY2018 (Table 2 contains a summary of balances). A recent revision of the CFA has temporarily augmented the US contribution and allowed Palau to increase withdrawals to approximately $15 million for FY2020 and onward.[6] The fund is now expected to maintain its nominal balance indefinitely, allowing for drawdowns in perpetuity, though recent volatility of investment returns threatens the real value of the fund. However, the terms of the CFA will expire in 2024 leaving Palau with the need for a fiscal adjustment. Conservative estimates find a gap of $5.8 million to make up for lost revenues; however, if all US assistance stops, the gap grows to $16 million annually (footnote 4). Non-compact grants are also a source of funds, though not as significant. These, mostly capital grants, have been consistent, but there is uncertainty whether they will continue due to the fact that Palau is now considered a high-income country.[7]

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3 ROP. 2019. Audited National Financial Statements.

4 PITIVITI, Graduate School USA and EconMAP. 2019. Economic Review, Palau FY 2018.

5 PITIVITI, Graduate School USA and EconMAP. 2019. Economic Brief, Palau FY 2018.

6 The drawdown amounts under the revised agreement, which was finally authorized in 2018, are 2018: $5 million; 2019: 10 million; 2020: $14.867 million; and 2021 and beyond: $15 million. Graduate School USA and EconMAP. 2019. Economic Review, Palau, FY 2018.

7 World Bank. 2020. World Bank Lending Groups. https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups.

5. Similar to other Pacific island nations, government operations are also dependent on tax collections from the tourism industry, which has virtually closed due to COVID-19. From FY2014 through FY2018 tax receipts remained consistent, averaging $49 million, about 20% of GDP.[8] However, projections for tax revenue now show a sharp decline, before rising again in FY2022. With no tourists arrivals until at least 2021, tax revenue is projected to fall by $11 million in FY2020 and another $19 million in 2021 (footnote 15); these declines correspond to increased expenditures resulting from the national response to COVID-19 through the recent Coronavirus Relief One-Stop Shop (CROSS) Act administered by the Ministry of Finance (MOF). The measures address the health and socioeconomic impacts of COVID-19 protecting the most vulnerable population and are funded through a one-time appropriation.[9]. The tourism industry is expected to recover in 2022 and 2023, bringing tax revenues back to normal.

B. Fiscal Summary

6. The revenue shortfalls will drive fiscal deficits for the first time in ten years. Before the economic shock of COVID-19, Palau recorded fiscal surpluses averaging 3.1% of GDP from FY2011 to FY2019, showing strong fiscal discipline. However, due to COVID-19 related revenue declines and increased expenditures, a fiscal deficit will reappear in FY2020. Deficits of $31.2 million (-12.2% of GDP), and $53.4 million (-23.8% of GDP) are projected for FY2020 and FY2021, respectively. The government estimates that additional funding of at least $46 million will be required over the next 2 years. (footnote 16)

7. In 2019, Palau’s public debt was classified as sustainable by the International Monetary Fund (IMF).[10] Now, new borrowing to support a COVID-19 recovery will be significant. If new loans are concessional, debt levels are expected to return to a downward trend in the medium-term as the economy recovers;[11] and, with sustained recovery, the public debt-to-GDP ratio can revert to the pre-COVID-19 level by FY2028.[12]

8. Palau’s public debt is mostly external and recorded at $91.2 million or 32.9% of GDP.[13] In the face of COVID-19 the government has approved additional borrowing of up to $60 million;[14] if accessed total external debt would exceed $150 million (56% of GDP).[15] A return to fiscal surpluses and fading global impacts of the pandemic, especially on the tourism sector, should bring relief in the medium term and cause a fairly swift decline in the debt ratio to 46.5% by FY2024.

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8 World Bank Development Economic Indicators and ROP Financial Statements FY2014 – FY2018.

9 ROP. RPPL 10-56. These programs are funded by two supplementary budgets, the first for an additional $6.9 million and the second for $20 million, making the COVID-19 response equivalent to 10% of GDP.[9] The congress has recently passed legislation authorizing additional borrowing of up to $60 million (22% GDP).[9]

10 IMF. Republic of Palau, IMF Country Report No. 19/43. 2019.

11 In addition to the pursuit of concessional lending, discussions are under way to arrange a debt deferment plan with external lenders of existing debt.

12 ADB. 2020. Proposed Countercyclical Support Facility Loan Republic of Palau: Health Expenditure and Livelihoods Support Program. Manila.

13 Domestic debt is limited to arrears and accounts payable, equivalent to just 1.4% of GDP as of FY2019. Graduate School USA and EconMAP. 2019. Economic Brief, Palau, FY 2018.

14 ROP. 2020. “COVID-19 Presidential Borrowing Act of 2020; House Bill No. 10-131-14s.

15 Includes debt of central government and public enterprises.

C. Contingent Liabilities

9. The government's exposure to contingent liability includes the Civil Service Pension Plan with net liability of $259 million.[16] Actuarial accounting has determined that liabilities may exceed assets as early as 2022, meaning that Palau may need to pay out annual benefits from public funds. The potential impact of this liability, which is 94% of GDP, is a source of concern for the independent auditor (footnote 16) and IMF.[17]

10. Second, state-owned enterprises (SOE) have taken on debt under government guarantees. These loans do not appear as liabilities on the Palau's balance sheet unless there is a default. Poor performance from SOEs places the government at risk, because as performance worsens, SOEs face increased likelihood of default, which would require the government to repay debts directly. SOEs also hold a large portion of the nation's long-term debt. Total external debt held by public enterprises in FY2019 was $22.7 million, which is 26%[18] of the total debt, and 8.5% of 2019 GDP.[19]

11. Best practice for contingent liabilities from IMF includes a series of actions including: (i) ascertaining the size of the government exposure; (ii) ensuring that guarantees are properly recorded and disclosed; (iii) adequate budget provisions to meet claims; (iv) if guarantees are sizeable, creating a reserve fund; (v) regulating the issuance of new guarantees through a policy framework; (vi) developing capacity to evaluate guarantee proposals and assess associated risks; and (vii) developing measures to mitigate risks.[20] Based on the messages of audited reports, the government has taken the first two actions. The government acknowledged the size of its exposure (action #1) and SOEs' loans, balances and payment schedules are included in the state audit reports (action #2). However, actions 3 through 7 remain in the planning process and ADB program will be supporting efforts towards actions 3, 6 and 7.

D. Contingent Liabilities from the Palau Public Utilities Corporation

12. PPUC is the largest SOE by assets listing ($97.43 million);[21] the next largest, National Development Bank of Palau lists $32.3 million in assets,[22] one third the size of the utility. PPUC also holds the highest amount of debt among all SOEs at $21.9 million, followed by Belau Submarine Cable Corporation holding the second most long-term debt, $18.73 million.

13. PPUC is the only SOE in Palau to have realized operational losses in 5 of the past 6 years. In FY2019, PPUC reported operating losses of $6.87 million (2.6% of GDP),[23] and cumulative losses from the past 5 years at $21 million (8% of 2019 GDP).[24] Allowable tariff adjustments were not implemented timely, and in 2018 Palau Parliament prohibited any upward movement of the

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[16] ROP (Deloitte). 2019. Independent Auditors' Reports on Internal Control and on Compliance. p. 22.

[17] IMF. 2019. Republic of Palau, IMF Country Report No. 19/43. Washington D.C.

[18] This figure is reported by Graduate School USA and the IMF and is used in the total public debt figure of $91.2 million in paragraph 34. However, total guaranteed debt from four SOEs' 2018 Audited Financial Statements is $43.9 (and may be as high as $62.8 million if NPCC debts to Rural Utility Service are counted). For a full summary of external debt see Annex 2 of Fiduciary Assessment. Questions about these debts remain unanswered at the time of writing.

[19] Graduate School USA. 2019. Palau FY2019 Economic Statistics (Preliminary). GDP figures are from this study.

[20] IMF. 2017. How to Strengthen the Management of Government Guarantees. Washington D.C. https://www.imf.org/~/media/Files/Publications/HowToNotes/howtonote1706.ashx

[21] PPUC Audited Statements FY2019 Draft. Assets prior to deferred outflow of resources from pension.

[22] NDBP. 2019. Audited Statements FY2018.

[23] PPUC. 2019. Audited Statements FY2019 Draft.

[24] PPUC. Various. Audited Statements FY 2014–-2018.

tariffs for water and electricity. Operational and managerial inefficiencies exacerbate this liquidity gap. In 2018 power grid losses were almost 20% of generated energy. Collection rates for billed electricity are less than 70%. The water and wastewater operations (WWO) portion of PPUC has not paid its electricity bill since 2017.[25] By FY2018 WWO accounted for 58% of PPUC's accounts receivables, or $2.8 million (14% of electricity revenues in 2018).[26]

14. As a result, PPUC requires the support of government to offset losses for operation and maintenance, fuel costs, and loan repayments. The government provided support on fragmented basis, through limited subsidies for operations, to reduce the effect of fuel prices on electricity, and as liquidity infusions for emergency activities. Cumulative contributions from the government to PPUC has been over $20 million since 2013 or 7.5% of GDP. Operational subsidies are approved by Parliament and have averaged $1.83 million annually over the last 8 years and totaled $14.65 million. Capital infusions have averaged $0.8 million and totaled $5.5 million.[27] Annual subsidies to PPUC was recorded at 1% of GDP despite the government's aim to make PPUC self-sustaining.

15. Poor financial performance at PPUC threatens to expose the government to PPUC's liability of $21.9 million, the equivalent of 8.2% of GDP. Operational losses by PPUC require the government and MOF for continuous liquidity support and closer oversight given increasing risk of PPUC insolvency without reforms. A new PPA with IPPs, with PPUC as the off-taker, will increase MOF's off-balance sheet liabilities as PPUC financial position and capacity to perform financial obligations are not confirmed.[28]

Table 3: PPUC Performance, 2014–2019

Item	2014	2015	2016	2017	2018	2019
Assets	73.7	70.6	76.7	90.0	100.0	97.4
Liabilities	28.8	27.5	28.4	36.3	46.4	52.0
Long-term debt	7.0	7.4	7.8	11.4	17.2	21.9
Operational gains (losses)	(2.2)	(2.0)	2.9	(3.3)	(4.2)	(8.4)
Operational subsidies	1.8	3.4	2.8	0	1.7	0.5
Capital grants	1.1	0.1	1.4	0.1	0.9	0.8

PPUC = Palau Public Utilities Corporation.
Source: PPUC Audited Financial Statements (2014–2019).

16. PPUC represents a source of largest fiscal risk to Palau adversely impacting potential for renewable energy target of 45% by IPPs. With present negotiations for potential 20MW solar generation by IPP the PPA's fiscal risk to Palau is estimated at $38 million.[29] Further, a significant investment in transmission and distribution will be required to evacuate all power from the new facility. Unless the required upgrades to the system are in place, PPUC may find itself buying power it cannot distribute. Under "take or pay" arrangement the government is likely to guarantee the PPA ensuring grid upgrades completed by PPUC. The combined total of PPUC debt and PPA

[25] Section 41 of the Utilities Consolidation Act prohibits the cross-subsidization between the electricity operations and WWO.
[26] PPUC. 2019. Audited Statements FY2018.
[27] From PPUC Financial statements 2013-18. 2019-20 figures from Congressional Appropriation bills 2019 and 2020.
[28] BSCC. 2019. Audited Statements FY2018.
[29] Figure assumes "Package A" from PEA RFP, 2019. Under this development package, IPP would deliver up to 20 GWH of electricity during the first 10 years of operation at $0.19/KWH.

(not including system upgrades) is estimated at $59.9 million (22% of GDP).[30] To respond to this exposure, the government has mandated the PEA to monitor PPAs with all IPPs reconciling contract terms with PPUC's financial position and capacity. ADB proposed program and reforms will enhance PPUC financial sustainability in mitigating the off-take risk under PPA.

[30] Consultant's estimate. PPUC external debt is $21.9 m. PPA value assumes "Package A" from PEA RFP, (2019), which is a 20 GWH/year delivery. Under this development package, IPP would deliver up to 20 GWH of electricity during the first 10 years of operation at $0.19/KWH. (20 X 10 X 0.19 X 10^6 = 38m). 21.9 + 38 = 59.9. GDP 2019 is 268.4. 59.9/268.4 = 22.3%.