



Technical Assistance Report

Project Number: 36376
December 2006

Kingdom of Tonga: Rationalization of Public Enterprises, Phase III (Financed by the Japan Special Fund)

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 15 October 2006)

Currency Unit	–	pa'anga (T\$)
T\$1.00	=	\$2.012
\$1.00	=	T\$0.497

ABBREVIATIONS

ADB	–	Asian Development Bank
CPD	–	Central Planning Department
EPSRP	–	Economic and Public Sector Reform Program
GDP	–	gross domestic product
MFEP	–	Ministry of Finance and Economic Planning
PED	–	Public Enterprise Division
SDP-8	–	Strategic Development Plan Eight, 2006/07—2008/09
TA	–	technical assistance

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	–	General intervention
Sector	–	Law, economic management and public policy
Subsector	–	Public finance and expenditure management
Themes	–	Governance, private sector development, capacity development
Subthemes	–	Financial and economic governance, privatization, organizational development

NOTES

- (i) The fiscal 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., FY2006 ends on 30 June 2006.
- (ii) In this report, "\$" refers to US dollars.

Vice President	C. L. Greenwood, Jr., Operations Group 2
Director General	P. Erquiaga, Pacific Department (PARD)
Regional Director	S. Jarvenpaa, South Pacific Subregional Office, PARD
Team Leader	Fernando Garcia, Principal Country Programs Specialist, PARD

I. INTRODUCTION

1. The Public Enterprises Act 2002 was enacted in 2002 as part of the Asian Development Bank's (ADB) assistance under the Economic and Public Sector Reform Program (EPSRP) loan.¹ Through implementation of this act, the Government of Tonga initiated a public enterprise reform program in 2003 with a fundamental reexamination of the role of the state and its engagement in business activities that, under normal circumstances, are better left to the private sector. ADB provided technical assistance (TA) entitled Rationalization of Public Enterprises² to help the Government (i) institute changes to corporate governance of public enterprises, (ii) implement a financial performance monitoring framework, (iii) train directors and senior officials on requirements of the Public Enterprises Act, and (iv) build the capacity of the Public Enterprise Unit to support the minister of finance in providing policy advice and in analyzing the performance of enterprises. This was followed by a small-scale TA entitled Rationalization of Public Enterprises, Phase II³ to assist with the privatization of the Sea Star Fishing Company, and to build the capacity of the Public Enterprise Division (PED) of the Ministry of Finance and Economic Planning (MFEP) to manage the public enterprise portfolio.

2. In response to a Government request during the Country Consultation Mission of 28 February–3 March 2006, ADB approved the inclusion of a TA entitled Rationalization of Public Enterprises, Phase III in its 2006 nonlending program in place of the proposed Implementation of Agriculture Sector Road Map. During the Country Consultation and TA Fact-Finding Mission that visited Tonga from 30 May to 1 June 2006, the Government and ADB reached understandings on the impact, outcome, outputs, implementation arrangements, cost, financing arrangements, and terms of reference of this TA. The proposed TA is consistent with the strategic objectives of *the Pacific Strategy for the Asian Development Bank 2005–2009*.⁴ The Vice President (Operations 2) approved the concept paper for the TA on 7 July 2006. The TA design and monitoring framework is in Appendix 1.⁵

II. ISSUES

3. The Government, with the assistance of ADB,⁶ approved its Strategic Development Plan Eight 2006/07–2008/09 (SDP-8), which presents the development vision, the medium-term national development goals, and the strategies for developing these goals for the country. In accordance with the SDP-8, the Government reconfirmed its interest in focusing ADB's assistance during the 2007–2009 Country Strategy and Program Update⁷ under a second phase of the EPSRP. This would encompass, under the eight goals of the SDP-8, the following areas: (i) sustainable fiscal balance; (ii) efficiency in public service delivery; (iii) financial sector development, including support for enhancement of monetary policy instruments and the independence of the National Reserve Bank of Tonga; (iv) private sector development with a

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, approved for SDR8.02 million in May).

² ADB. 2003. *Technical Assistance to the Kingdom of Tonga for Rationalization of Public Enterprises*. Manila (TA 4111-TON, approved for \$515,000 in May).

³ ADB. 2004. *Technical Assistance to the Kingdom of Tonga for Public Enterprise Reform Phase II*. Manila (TA 4514-TON, approved for \$150,000 in December).

⁴ ADB. 2004. *Responding to the Priorities of the Poor: A Pacific Strategy for the Asian Development Bank 2005–2009*. Manila.

⁵ The TA first appeared in *ADB Business Opportunities* on 20 July 2006.

⁶ ADB. 2004. *Technical Assistance to the Kingdom of Tonga for Integrated Strategic Planning, Medium-Term Fiscal Framework and Budgeting*. Manila (TA 4510-TON, approved for \$300,000 in December).

⁷ ADB. 2004. *Country Strategy and Program Update (2005-2006: Tonga)*. Manila.

focus on building an enabling environment for expanding private sector participation in the economy; and (v) mitigation of social impacts. In ADB's Country Partnership Strategy for 2007–2009, the Government envisages a carefully designed private sector development program, supporting optimization of resource productivity, as a core counterpart to the second phase of the EPRSP.

4. Improving corporate governance of public enterprises, including corporatizing and privatizing, is integral component of the economic and public sector reform. Reducing Government expenditure through divestment, particularly raising revenue through asset sales could contribute significantly to the fiscal adjustment. Therefore, SDP-8 establishes as Goal 1 the need to “create a better governance environment” by “strengthening corporate governance in the public enterprise sector through enforcement of the Public Enterprises Act” (Strategy 9), and “corporatizing selected Government commercial activities and privatizing selected public enterprises” (Strategy 10). In addition, SDP-8 highlights the need to “formulate and implement a plan for outsourcing Government services that encompasses capacity building for contract design, contract management and internal audit” (Strategy 4). To move decisively toward these objectives, the Government has established a multi-ministry Privatization Task Force—supported by MFEP's PED—that is responsible for reviewing and executing divestiture opportunities for a long list of public enterprises, including (i) the Post Office, (ii) Talamahu Market, (iii) the Tonga Chronicle, (iv) Fua'motu Airport, (v) the Tapuhia Waste Management Authority, (vi) the Leiola Duty Free, and (vii) the Tonga Investment Ltd. The 2005 Alternative Service Delivery report⁸ identified additional privatization opportunities, including Tongatapu Machinery Pool, Tonga Timber, Tonga Print, and Tonga Corporation. In this connection, the Government requested TA from ADB to accelerate public enterprise rationalization, including privatization processes. Such assistance is essential, given the specific, technical nature of the work involved, and difficulties in recruiting qualified staff to fill MFEP vacancies.

5. The TA for the first phase of the rationalization of public enterprises (footnote 2) was designed to prepare for a loan that would provide funds for an ongoing program of privatization and financial reconstruction of public enterprises. During the TA, ADB and the Government recognized that a loan was not required as the Government was fully committed to the public enterprises reform program, and the budgeted resources and expected proceeds from the initial sales could cover the costs associated with rationalization and privatization. However, this is no longer the case due to the tightened financial situation. Under Phase II, the Government had agreed to fund some services ancillary to those provided by ADB's consultants (e.g., auditing, asset valuation, etc.). However, the fiscal conditions have exacerbated further due to the recent civil service strike outcome and the costs related to the recovery of the riots experienced by the central commercial district in Nuku'alofa in November 2006. Thus, under the current financial situation, the Government would not be able to finance alone the preparation of the remaining, but necessary, rationalizations.

6. The initial Rationalization of Public Enterprises TA identified the main elements needed to support a continuing reform program. However, it did not establish a rigid timetable to enable flexibility in acting on particular public enterprises. The final report provides a comprehensive review of the public enterprise sector, the legislative framework, and Government management of its investment, as well as each enterprise and significant trading activity of Government. The TA also concluded that future external support should be targeted tightly, locally managed, and accompanied by skills transfer. To achieve good results consistently from public enterprise

⁸ Pricewaterhouse Coopers. 2005. *Vinstar/Government of Tonga, Phase 1 Alternative Service Delivery: Approach and Early Wins*. Nuku'alofa.

reforms, sound commercial processes are urgently needed. These should be backed by more expert commercial, financial, and legal advice that is available within the Government or the Tongan private sector. On 30 August 2006, the Government provided the following list of public enterprises to be rationalized with the assistance of the proposed TA: (i) International Dateline Hotel, (ii) Leiola Duty Free Limited, (iii) Shipping Cooperation of Polynesia, (iv) Tonga Machinery Pool, and (v) Tonga Timber.

7. To strengthen public sector capability to manage and monitor performance of the public enterprises, the TA will include skills transfer to local staff as a key objective and a target outcome that will be a deliverable in the consultants' contract. Additional capacity building is needed to build upon the competencies developed under the first phase to harness within the Government capacity to monitor public enterprise governance and guide performance improvement, including development of private-public partnership arrangements and privatization processes.

8. Strengthening the management of public enterprises that will remain majority-owned by the Government in the short- and medium-term is another important area that requires assistance, as well as provision of advice for public enterprise performance improvement. To improve accountability and transparency of public enterprise operations, MFEP will continue to require that public enterprises formulate statements of corporate intent and meet their reporting obligations under the Public Enterprise Act. Further, MFEP will work with the relevant line ministries to clarify public enterprises' community service obligations, and to provide for more transparent financing of these obligations.

9. The TA will support the Government's goals and strategies established in the SDP-8 as a crucial instrument for advancing economic and public sector reforms. The proposed TA for Rationalization of Public Enterprises, Phase III, continues the progress developed under previous ADB-funded TAs and is aimed at rationalizing the performance of the public enterprises by providing expert skills for an application of options to improve the performance of the public enterprise portfolio, including through outsourcing, performance-based contracting, concessions, as well as the preferred option of disengagement from public enterprises through privatization.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

10. The overall impact of the TA is to reduce fiscal expenditure pressure by off-loading the Government's responsibilities for selected public enterprises. It also will develop alternative, private sector-driven modalities for service provision. The TA is in line with ADB's strategy for Tonga that focuses on economic governance and improvement of fiscal conditions among its broader macroeconomic management objectives. The TA will help Government execute the public enterprise reforms envisaged under the Public Enterprise Act 2002, detailed in the final report of the Phase I and partly implemented under the Phase II.

11. The expected outcome is improved fiscal governance through rationalization of public enterprise portfolio, particularly in terms of reducing fiscal burden resulting from ailing public enterprises, realizing revenues through disengagement from public assets, and expanding private investment to fuel private sector-led economic growth. The TA will assist the Privatization Task Force and PED with the rationalization process for selected public enterprises. The public enterprise reforms will (i) strengthen the Government's overall financial position; (ii)

increase the operational and financial autonomy for public enterprise management, thereby improving the performance of public enterprises; and (iii) build the capacity of civil service staff involved in public enterprise oversight.

B. Methodology and Key Activities

12. The TA will assist the Government with the rationalization of selected public enterprises that the Privatization Task Force is conducting under the direction of MFEP with the support of PED. Specifically, the TA will (i) determine the rationalization strategy for each selected company; (ii) assist PED in the implementation of the strategy adopted for each company, based on the feedback of the steering committee, by providing detailed technical, financial, and regulatory advice; (iii) provide extensive technical support for the due diligence process based on the option taken; (iv) support the valuation process in the case of privatization; (v) prepare a rationalization plan for each selected enterprise; (vi) assist with the implementation of the rationalization plans; and (vii) provide capacity building for the relevant Government departments.

13. The lead international consultant under the TA will be based in Tonga on an interim basis to support with the rationalization of public enterprises. Skills transfer and capacity building for local PED staff in technical, management, and regulatory areas will be strongly emphasized. Other international and national consultants will be used for short-term specialist advice, as appropriate. The lead consultant, assisted by short-term consultants, also will provide training and support to staff in other ministries responsible for oversight of public enterprises that will remain majority-owned by the Government in the short and medium term.

C. Cost and Financing

14. The TA is estimated to cost the equivalent of \$500,000. The Government has asked ADB to finance \$400,000 through a grant from the Japan Special Fund, funded by the Government of Japan. The Government will provide the equivalent of \$100,000 for local currency costs in the form of office space, adequate counterpart staff, local transportation, workshops, and seminars. The detailed cost estimates and financing plan are in Appendix 2.

D. Implementation Arrangements

15. MFEP will be the Executing Agency for the TA, with PED closely coordinating with other departments that support the respective ministries in supervising and monitoring the performance of public enterprises. The Privatization Task Force will serve as the steering committee for the TA, coordinating its implementation. The steering committee also will provide overall policy guidance to the consultants, and ensure the quality of the deliverables.

16. An international consulting firm in association with national consultants will carry out the TA from February 2007 to May 2008. ADB will engage the consultants in accordance with its *Guidelines on the Use of Consultants* (April 2006, as amended from time to time). The TA will require about 28 person-months of consulting services, comprising about 13 person-months of international consultants and about 15 person-months of national consultants, to carry out the activities as defined in the terms of reference. The international consultants will have expertise in public enterprise reform (team leader consultant) and financial analysis. The national consultants will have expertise in financial analysis and law. Procurement under the TA will be in accordance with ADB's *Procurement Guidelines* (April 2006, as amended from time to time), and equipment will be handed over to the Executing Agency upon completion of the TA.

17. The team leader and the short-term consultants will work closely with the Government, particularly with the minister of finance, and the staff of PED and other ministries responsible for oversight of public enterprises. MFEP and other concerned ministries will ensure timely access to relevant information on public enterprises. During TA implementation, workshops will be organized with MFEP, PED, other Government agencies, ADB, the consultants, and other stakeholders. Appropriate training sessions will be organized for PED officers and public enterprise management staff.

18. Throughout the TA, the consultants will submit brief monthly progress reports, summarizing TA activities, issues, and constraints. In addition, four major reports will be submitted: (i) inception report, within 2 weeks of commencement of assignment; (ii) interim report, 6 months after the commencement of the assignment; (iii) draft final report, 13 months after commencement of assignment; and (iv) final report. The Government and ADB will comment on the inception, interim, and draft final report. The final report will be submitted within 3 weeks after the tripartite meeting has discussed the draft final report.

IV. THE PRESIDENT'S DECISION

19. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$400,000 on a grant basis to the Government of Tonga for the Rationalization of Public Enterprises, Phase III, and hereby reports this action to the Board.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
<p>Impact</p> <p>Improved fiscal governance releasing fiscal resources from public enterprises</p> <p>Increased private sector investment in service provision</p>	<p>Disengagement from public enterprises</p> <p>Increased private sector share of GDP and of formal employment</p>	<p>Government statistics and economic reports, e.g., Quarterly Review of the Reserve Bank of Tonga</p>	<p>Political risk factors not affect investor confidence</p>
<p>Outcome</p> <p>Improved public sector governance through the rationalization of the public enterprise portfolio, preferably through divestiture, but also through private public partnership options of concessions, performance-based contracts, and outsourcing</p>	<p>Improved rate of return on the portfolio of public enterprises</p> <p>Reduced fiscal engagement in public enterprise sector</p> <p>Increase in private sector investment as share of GDP</p>	<p>MFEP and PED records</p> <p>MFEP and PED and consultant reports</p> <p>ADB review missions</p>	<p>Assumption</p> <p>Government commitment to economic and public sector reforms can be maintained through the implementation period of the SDP-8</p>
<p>Outputs</p> <p>Rationalization and/or privatization of at least four public enterprises</p> <p>Enhanced technical, management, and regulatory capacity in Public Enterprise Division (PED)</p>	<p>Rationalization through appropriate public private partnership arrangements for service provision to reduce fiscal expenditure to public enterprises, preferably through privatization, concessions, performance-based contracting, and outsourcing</p> <p>Assets divested in under transparent procedures and competitive arrangements</p> <p>Continuity of and universal access to public services, and rationalization of social service obligations, as required, under divested or contracted service provision</p> <p>At least five PED high- and medium-level officers properly trained, and with capacity for handling privatization and public private partnership tender processes of public enterprises</p>	<p>MFEP and PED records</p> <p>MFEP and PED and consultant reports</p> <p>ADB review missions</p>	<p>Assumption</p> <p>Market exists for divestment of selected public enterprises.</p> <p>Risk</p> <p>Political instability not allowing the rationalization processes to progress as planned</p>

Activities with Milestones	Inputs
<ol style="list-style-type: none"> 1. Rationalization strategy for the selected public enterprises submitted to PED and the steering committee 2 months after the commencement of the assignment. 2. Implementation of the agreed rationalization strategy for each selected public enterprise with a detailed technical, financial, and regulatory road map to PED and other relevant departments for the implementation of the strategy. 3. Support to the due diligence process based on the option taken for each identified public enterprises with due diligence reports submitted and endorsed by the Government and ADB for target public enterprises within 4.5 months after the commencement of the assignment. 4. Support to the valuation process in the case of privatization with the valuation process concluded and report endorsed by ADB and the Government's Cabinet 4.5 months after the commencement of the assignment. 5. A rationalization plan for each selected public enterprise with rationalization plans submitted and endorsed by ADB and the Government 6 months after the commencement of the assignment. 6. Support to implementation of the rationalization plans with rationalization plans substantially implemented within 13 months after the commencement of the assignment. 7. Capacity building for the relevant Government departments with skills transfer and capacity building for local PED staff in technical, management, and regulatory areas and workshops will be held in line with achievement of specific milestones by the conclusion of the TA. 	<ul style="list-style-type: none"> • ADB Japan Special Fund grant: \$400,000 • Government in-kind contributions equivalent to \$100,000, including office space, adequate counterpart staff, local transportation, workshops, and seminars • Consultants • Other stakeholders

ADB = Asian Development Bank, MFEP = Ministry of Finance and Economic Planning, PED = Public Enterprise Division, SDP-8 = Strategic Development Plan Eight, 2006/07—2008/09.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Cost
A. Asian Development Bank Financing^a	
1. Consultants	
a. Remuneration and Per Diem	
i. International Consultants	266.0
ii. National Consultants	55.0
b. International and Local Travel	19.0
c. Reports and Communications	9.0
2. Equipment	4.0
3. Training, Seminars, and Conferences	
a. Facilitators	0.0
b. Training Program	5.0
4. Surveys	0.0
5. Miscellaneous Administration and Support Costs	2.0
6. Contingencies	40.0
Subtotal (A)	400.0
B. Government Financing^b	
1. Office Accommodation and Transport	46.0
2. Remuneration and Per Diem of Counterpart Staff	44.0
3. Workshops and Seminars	10.0
Subtotal (B)	100.0
Total	500.0

^a Financed by the Japan Special Fund, funded by the Government of Japan.

^b Financed by in-kind contributions.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. Scope

1. The consultants will undertake the assignment under the leadership of the public enterprise reform specialist and team leader. The assignment includes, but is not limited to, the following tasks:

- (i) Review the findings included in the final report of TA 4111-TON: Rationalization of Public Enterprises,⁹ and other previous studies and documents relevant for the assignment.
- (ii) Analyze the public enterprise manuals and guidelines compiled in Phase I, and further develop these as appropriate for ongoing Public Enterprise Division (PED) use.
- (iii) Develop a suitable rationalization strategy for at least four priority selected public enterprises. For privatizations, this will include, but not be limited to, (a) identifying critical business and regulatory issues to be addressed, (b) implementing processes to enable change and/or legislation to address such issues, (c) identifying an appropriate strategy to sell equity, and (d) implementing adequate processes to attract potential buyers and manage the sale.
- (iv) Provide detailed technical advice to PED on rationalization or privatization for each of the targeted public enterprises, including corporate and financial restructuring, asset valuation, legal status, taxation treatment, regulatory arrangements, and associated labor issues.
- (v) Provide appropriate assistance to safeguard public and social services through concession contracts and public service obligations, and prepare a strategy for developing Government regulatory function in the affected areas.
- (vi) Provide extensive technical support for the due diligence process based on the option taken.
- (vii) Provide extensive technical support for the valuation process in case of privatization.
- (viii) Develop detailed rationalization plans, in consultation with local counterparts, for each of the rationalizations, and provide extensive technical support for its implementation.
- (ix) Through on-the-job training and training seminars, mentor and build the skills and capacity of PED staff—and other Government officials, as required—to lead the rationalization of public enterprises.
- (x) Provide advice on strengthening management of individual public enterprises that are to remain majority-owned by Government in the short and medium term, as well as specific proposals for improved performance.

⁹ ADB. 2003. *Technical Assistance to the Kingdom of Tonga for Rationalization of Public Enterprises*. Manila (TA 4111-TON, approved for \$515,000 in May).

2. The team leader and the short-term consultants will work closely with the Government, particularly with the minister of finance, the staff of PED and other ministries responsible for oversight of public enterprises. The Ministry of Finance and Economic Planning (MFEP) and other concerned ministries will ensure timely access to relevant information related to public enterprises. During technical assistance (TA) implementation, workshops will be organized with MFEP, PED, other Government agencies, Asian Development Bank (ADB), the consultants, and other stakeholders. Appropriate training sessions will be organized for PED officers and public enterprise management staff.

B. Reporting Requirements

3. The consultants will prepare and submit the following reports to MFEP and the ADB:

- (i) inception report, within 2 weeks of commencement of assignment;
- (ii) interim report, 6 months after the commencement of the assignment;
- (iii) draft final report, 13 months after commencement of assignment; and
- (iv) final report.

4. In addition to the four major reports, the consultants will submit short monthly progress reports, summarizing TA activities, issues, and constraints throughout the TA.

5. The Government and ADB will comment on the draft final report. The final report will be submitted within 3 weeks after the tripartite meeting to discuss the draft final report.