



Report and Recommendation of the President to the Board of Directors

INTERNAL

Project Number: 54151-003
July 2022

Proposed Policy-Based Loan for Subprogram 2 Republic of Palau: Palau Public Utilities Corporation Reform Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 30 June 2022)

The currency unit of Palau is the United States dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
GDP	–	gross domestic product
IMF	–	International Monetary Fund
IPP	–	independent power producer
MOF	–	Ministry of Finance
PEWA	–	Palau Energy and Water Administration
PPA	–	power purchase agreement
PPP	–	public–private partnership
P3F	–	post-program partnership framework
PPUC	–	Palau Public Utilities Corporation
SCI	–	statement of corporate intent
SOE	–	state-owned enterprise
TA	–	technical assistance
WWO	–	water and wastewater operation

NOTES

- (i) The fiscal year (FY) of the Government of Palau and its agencies ends on 30 September. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY 2022 ends on 30 September 2022.
- (ii) In this report, “\$” refers to United States dollars.

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^a Outposted to the Palau Pacific Country Office.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 54151-003	
Project Name	Palau Public Utilities Corporation Reform Program (Subprogram 2)	Department/Division	PARD/PAEN
Country	Palau, Republic of	Executing Agency	Ministry of Finance
Borrower	Republic of Palau		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=54151-003-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=54151-003-PortAtaGlance		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Water and other urban infrastructure and services	Urban water supply		4.000
Energy	Energy utility services		1.000
	Total		5.000
3. Operational Priorities		Climate Change Information	
✓ OP1: Addressing remaining poverty and reducing inequalities		GHG reductions (tons per annum)	0
✓ OP2: Accelerating progress in gender equality		Climate Change impact on the Project	Low
✓ OP3: Tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability			
✓ OP4: Making cities more livable		ADB Financing	
✓ OP6: Strengthening governance and institutional capacity		Adaptation (\$ million)	0.000
		Mitigation (\$ million)	0.770
		Cofinancing	
		Adaptation (\$ million)	0.000
		Mitigation (\$ million)	0.000
Sustainable Development Goals		Gender Equity and Mainstreaming	
SDG 1.b		Effective gender mainstreaming (EGM)	✓
SDG 5.c			
SDG 6.4		Poverty Targeting	
SDG 7.b		Geographic Targeting	✓
SDG 10.2			
SDG 13.a			
4. Risk Categorization:	Low		
5. Safeguard Categorization	Environment: C	Involuntary Resettlement: C	Indigenous Peoples: C
6. Financing			
Modality and Sources		Amount (\$ million)	
ADB		5.000	
Sovereign Programmatic Approach Policy-Based Lending (Concessional Loan): Ordinary capital resources		5.000	
Cofinancing		0.000	
None		0.000	
Counterpart		0.000	
None		0.000	
Total		5.000	
Currency of ADB Financing: US Dollar			

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Republic of Palau for subprogram 2 of the Palau Public Utilities Corporation Reform Program.

2. The programmatic approach, consisting of two subprograms, aims to strengthen state-owned enterprises (SOEs) in Palau by (i) improving the corporate governance and financial management of Palau's electricity and water utility company, Palau Public Utilities Corporation (PPUC); and (ii) providing an enabling environment for private sector participation in the electricity and water subsectors.¹ Through subprogram 1, the government adopted cost-reflective tariffs for electricity and enhanced PPUC's financial management and corporate governance. All policy actions achieved under subprogram 1 remain in effect. Subprogram 2 builds on achievements of subprogram 1 and focuses mostly on tariff reforms for PPUC's water and wastewater operations (WWO) and remaining cross-sector reforms in financial management and corporate governance to maximize synergies between energy operations and WWO. The programmatic approach allows a longer horizon to implement politically sensitive reforms in the energy and water and wastewater sectors including creating an appropriate regulatory environment and implementing cost-reflective tariffs for WWO. The program is consistent with the Asian Development Bank (ADB) Strategy 2030 operational priorities 1, 2, 3, 4, and 6 on strengthening governance and institutional capacity (including SOE reforms to improve service delivery) and accelerating progress in gender equality.²

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Macroeconomic context.** Palau is a small island developing state with a population of about 18,200 (as of 2022) and a land area of 458 square kilometers. It is heavily dependent on revenues from tourism and services, which contributed almost 55% of annual gross domestic product (GDP) and employed three-quarters of the formal workforce before the coronavirus disease (COVID-19) pandemic.³ However, tourism has struggled since fiscal year (FY) 2016, resulting in successive GDP contractions averaging 1.3% during FY2016–FY2019.⁴ Development grants under Palau's Compact of Free Association with the United States, expected to expire in FY2024, have contributed substantially to a per capita gross national income of \$14,786 in FY2020.

4. **Fiscal management.** Before COVID-19, Palau maintained an annual fiscal surplus averaging the equivalent of 3.0% of GDP during FY2011–FY2019, denoting solid fiscal management. The surplus was facilitated by tax and revenue reforms and control of the public sector wage bill. A track record of fiscal prudence allowed Palau to build buffers ahead of the pandemic. Public debt, estimated as the equivalent of about 38.6% of GDP in FY2019, was

¹ Asian Development Bank (ADB). 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy Based Loan for Subprogram 1 and Technical Assistance Grant to the Republic of Palau for the Palau Public Utilities Corporation Reform Program*. Manila.

² ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

³ United Nations Department of Economic and Social Affairs. [EVI Indicators](#) (accessed 21 November 2021).

⁴ From a peak of nearly 170,000 tourists in FY2015, arrivals declined to less than 90,000 in FY2019. The drop was caused by a variety of factors, including a drought that affected water supply in hotels and resorts, restrictions on tour groups from the People's Republic of China, and subsequent reductions in flight services because of weak demand.

considered sustainable. PPUC required subsidies averaging \$1.5 million in 5 of the 7 years from FY2013 to FY2019, as tariffs were set below full cost recovery.

5. **Coronavirus disease impacts.** The economy was severely impacted by the pandemic. To prevent the transmission of COVID-19, Palau, like other Pacific nations, closed its borders in March 2020. The economy contracted by 9.7% in FY2020 and by an estimated 17.1% in FY2021. The combination of the Coronavirus Relief One Stop Shop (CROSS) Act and United States Coronavirus Aid, Relief, and Economic Security (CARES) Act acted to mitigate COVID-19's adverse impact on employment and helped avoid widespread poverty.⁵ With the drastic decline in revenues and increased health and social expenditures, fiscal deficits averaging 15.2% were recorded in FY2020–FY2021 (Table 1). With effects of COVID-19 and reduced tourism, demand for utility services (electricity, water, and sewage) is reduced. The pandemic's impacts on PPUC's financial performance, along with corresponding assistance measures, particularly an expanded lifeline utility subsidy under the government's CROSS program, translated into additional temporary fiscal risks.

Table 1: Selected Fiscal and Economic Indicators
(% of GDP, unless otherwise stated)

Item	2018	2019	2020	2021e	2022p	2023p
Real GDP growth (% change)	(0.1)	(1.9)	(9.7)	(17.1)	9.4	18.3
Change in CPI (% annual average)	2.0	0.6	0.7	0.5	4.3	4.2
Central government budget						
Total revenue	44.5	44.5	47.4	46.3	41.2	38.0
Tax revenue	21.2	20.4	18.9	14.7	14.3	16.3
Nontax revenue	5.9	7.4	5.0	7.4	5.9	6.5
Grants	17.3	16.7	23.4	24.2	21.0	15.1
Total expenditure	38.2	44.1	58.3	65.8	53.9	41.1
Recurrent	35.9	39.6	52.3	61.3	48.9	36.7
Capital	2.3	4.5	6.1	4.5	5.0	4.4
Fiscal balance	6.3	0.4	(10.9)	(19.5)	(12.6)	(3.2)
Excluding external grants	(11.1)	(16.3)	(34.3)	(43.7)	(33.6)	(18.2)
Public debt	37.1	38.6	62.1	85.7	90.3	74.0
of which: External debt	32.2	33.9	58.1	80.9	86.0	70.5
Nominal GDP (\$ million)	284.7	274.2	257.7	216.2	242.7	294.9

() = negative, CPI = consumer price index, e = estimate, GDP = gross domestic product, p = projection.

Sources: Asian Development Outlook database and International Monetary Fund. 2021. Republic of Palau: 2021 Article IV Consultation—Press Release; staff report; and Statement by the Executive Director for the Republic of Palau. *IMF Country Report No. 21/263*. Washington, DC.

6. **Economic and fiscal outlook.** With reopening in July 2021 to all vaccinated travelers, primarily through restored flight connections via Guam, the economy is expected to grow 9.4% in FY2022 and 18.3% in FY2023. ADB assesses the general direction of macroeconomic policies to be sound, with a projected rise in tax revenues and expenditure restraints (Table 1). The fiscal deficit is projected to decline from 12.6% of GDP in FY2022 to 3.2% by FY2024. The public debt–GDP ratio is seen to peak at 90.3% of GDP in FY2022 to help meet development financing needs but to decline steadily thereafter with sustained economic growth. Ongoing SOE reforms and phasing out of subsidies to utilities for sustaining their operations and liquidity, along with broader public sector management reforms, will be crucial to manage public debt and associated risks.

7. Achieving sustainable economic growth is complex and context specific in ADB's Pacific developing member countries. However, the provision of market-augmented public goods, such

⁵ Republic of Palau. 2021. EconMap. *The Road to Recovery*. The Graduate School USA's Pacific and Virgin Islands Training Initiatives (PITI-VITI) further updates the economic impact of COVID-19 and strategies for mitigation in Palau.

as electricity, water, and sanitation, is a key determinant of the quality of life and, hence, of how attractive a country is to private investment.⁶

8. **Energy sector context.** Since 2010, the government has implemented several significant energy reforms, including (i) signing into law the Palau Energy Act and creating its regulatory framework, (ii) setting a renewable energy target of 45% by 2025,⁷ and (iii) approving energy efficiency benchmarks and tariff methodology. Palau remains highly dependent on imported fossil fuel, which comprises 95% of energy generation, driving the high cost of electricity. Supported by subprogram 1, the government approved a grid capacity plan for renewable energy and transmission expansion for power evacuation from independent power producers (IPPs). The policies have resulted in the first public–private partnership (PPP) with an independent renewable power producer advised by ADB.⁸ To improve its quality of supply and achieve benchmark targets, PPUC developed a sustainable investment program to modernize energy infrastructure, phasing out depreciated assets and prioritizing renewable energy evacuation capacity. Establishing a reliable and efficient grid with financially sustainable management will attract more private sector investment in renewable energy and improve sector performance.

9. **Water supply and sanitation.** With ADB assistance, Palau established legal and regulatory frameworks for commercial WWO.⁹ About 96% of Palau’s population has access to public water supply systems. The Koror–Airai water supply system services more than 96% of the population of Koror–Airai. Water supply systems outside Koror–Airai are in poor condition and service delivery quality is low. Frequent water outages in outlying states have a significant impact on women’s time poverty. Palau has a sanitation policy and a sewerage master plan for Koror until 2035. Priority investments identified in the Koror sewerage master plan are being delivered under the ADB-financed Koror–Airai Sanitation Project.¹⁰ Without a designated oversight agency or regulator for WWO, the government undertook the combined functions of planning, investment, and discretionary directives, undermining WWO’s sustainability.

10. **Palau Public Utilities Corporation.** PPUC was established in 1994 as a government-owned utility for power generation, transmission, and distribution, and became responsible for the provision of WWO in 2013.¹¹ Energy represents about 80% and WWO 20% of PPUC’s consolidated revenues. Women are underrepresented among PPUC staff, and the company made little effort to undertake institutional gender-mainstreaming initiatives or proactive actions to increase women’s employment. In FY2016, PPUC almost achieved its target of full cost recovery for energy and WWO, as total revenue rose to more than 90% of total operating expenses. However, in 2017, the Olbiil Era Kelulau froze tariffs for electricity and WWO because

⁶ Public goods, such as electricity, water, and sanitation priced at full cost recovery and supplied at commercial terms to consumers.

⁷ Government of Palau. 2015. *Intended Nationally Determined Contribution under the United Nations Framework Convention on Climate Change*. Ngerulmud.

⁸ This PPP intervention was supported by ADB’s Office of Public–Private Partnership and funded by the Asia Pacific Project Preparation Facility.

⁹ Palau adopted legislation to establish a corporatized water supply and sewerage entity operating on commercial principles and the National Water Resources Management Plan in 2010. At the time, independent regulation for WWO was not foreseen. ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Palau for the Water Sector Improvement Program*. Manila. (Loan 2691-PAL and Loan 2692-PAL).

¹⁰ ADB. 2013. [Republic of Palau: Koror–Airai Sanitation Project](#). Manila. The project constructed 2.2 kilometers of gravity sewers and 3.1 kilometers of force mains, upgraded two major sewage pump stations, and constructed two sewage pumping stations and a tertiary sewage treatment plant at Malakal through a design–build–manage contract.

¹¹ Republic of Palau. 2013. *Utilities Consolidation Act*. Ngerulmud.

of concerns about perceived service costs and quality.¹² PPUC has since incurred significant losses and has insufficient revenue to cover its basic operations without government support.

11. **Weak governance and transparency.** The PPUC's continued reliance on state subsidies has resulted in significant public sector influence over its governance, affecting the quality of disclosure and performance. Historically, the PPUC board was focused on basic legal compliance and was rarely held accountable for performance. Under subprogram 1, the PPUC board adopted its Code of Corporate Governance based on the Organisation for Economic Co-operation and Development's Corporate Governance Guidelines for SOEs (2015) and operationalized audit, risk, and compliance management aligned with international standards. PPUC implemented gender-sensitive human resource management procedures, including flexible working arrangements, introduction of parental leave, and workplace harassment and discrimination policies (including on gender-based discrimination and sexual harassment). However, further reforms are needed to ensure open, inclusive, and transparent nomination and appointment of the board and management with adequate experience to deal with poor governance, which accentuates sector inefficiencies and adverse impacts on PPUC performance.

12. **Deteriorating performance of the Palau Public Utilities Corporation and inadequate tariffs for water and wastewater operations.** PPUC is Palau's largest SOE and its poor performance is a major economic burden, imposing high risks to fiscal and financial sustainability. Since 2013, PPUC, the only SOE that has failed to operate commercially, has incurred losses every year, totaling \$31 million by 2021 or 12% of GDP.¹³ The government aims to make PPUC sustainable through cost-recovery mechanisms involving regular automatic quarterly tariff adjustments for fuel costs. With tariff reforms under subprogram 1, PPUC was able to recover all operating (nonfuel) costs for energy. However, recovery is jeopardized by WWO losses estimated at about \$5 million annually because of revenues below cost recovery and network losses of more than 40%.¹⁴ Negative profit from WWO and deferred payables for electricity have resulted in PPUC's equity eroding by 20% in FY2019–FY2021. The COVID-19 pandemic has exacerbated PPUC revenues because of halted tourism and other commercial consumer demand for electricity.¹⁵ The government imposed a moratorium on fuel price increase under the Automatic Fuel Price Adjustment Clause, compensated by a one-time state subsidy for fuel.¹⁶ On a consolidated basis, PPUC's liquidity remained negative and the utility accumulated operating losses exceeding \$7 million (3% of GDP) in FY2021. PPUC has maintained its liquidity by deferring all maintenance and capital works. Delayed investments in WWO infrastructure have resulted in high losses and unsafe water supply for consumers, particularly in outer states.¹⁷ With significant network losses in water supply, PPUC is in urgent need of investments to improve WWO quality. However, WWO investments would be unsustainable without comprehensive regulation and tariff reforms.

13. **Reliance on government support and widening fiscal risk.** More than 85% of public debt is owned by SOEs, and PPUC is the single largest borrower, with outstanding debt of \$23.3 million (33% of SOEs' total debt or 9% of GDP). With a widening liquidity gap, PPUC requires

¹² Olbiil Era Kelulau, the bicameral National Congress, is made up of the House of Delegates and the Senate.

¹³ PPUC. 2020. *PPUC Audited Statements, FY2014–FY2018*. Koror.

¹⁴ Estimated cash-based cost recovery ratio for WWO was less than 50% in 2019–2020 (PPUC 2020).

¹⁵ Energy operations contribute to about 73% of PPUC's consolidated revenue.

¹⁶ The clause is intended to be updated quarterly, allowing PPUC to pass on its full costs of fuel to end users. The moratorium in FY2021 was a one-time action to minimize the drastic increase in fuel prices in global markets. The moratorium does not impact tariff reforms under subprogram 1 given that PPUC is able to fully recover its operation and maintenance costs.

¹⁷ Households in outlying states do not use piped water without boiling it first; they also use catchment basins to harvest rainwater or purchase bottled water for drinking.

continuous government support for WWO to remain solvent. PPUC is heavily dependent on annual operational subsidies to maintain WWO infrastructure. Since 2013, PPUC has received more than \$20.5 million (7.5% of GDP) in state subsidies, comprising operational subsidies of \$15 million and an equity injection of \$5.5 million. Without reforms, the government will need to increase its subsidies to PPUC by at least 100% (equivalent to an additional 10% of GDP) over the next 5 years.

14. **Lack of private investment in energy.** PPUC depends heavily on subsidies, with no access to private capital for energy investments. With fuel expenses making up more than 65% of generation costs, renewable energy is key to reducing costs. The government has prioritized the transition to renewable energy by introducing long-term concessions for IPPs. While power purchase agreements (PPAs) are instrumental for hedging IPPs' operational risks, PPUC's underperformance and negative liquidity is a key country risk in attracting IPPs. The government's contingent liability associated with PPAs to keep PPUC solvent is estimated at about 1% of GDP annually.¹⁸ The grid has not been augmented and the network has not been upgraded as required to meet its renewable energy target of 45% by 2025.

B. Policy Reform, ADB's Value Addition, and Sustainability

15. **Government's reform agenda.** The strategy to develop water and sanitation is guided by the Water Policy (2012) and the Water and Sanitation Master Plan (2011–2036).¹⁹ Both remain relevant. The government adopted a strong electricity and WWO reform agenda by (i) prioritizing regulatory reforms to replace subsidies with cost-recovery tariffs for PPUC's sustainability, and (ii) leveraging private investments to meet the renewable energy target of 45% by 2025.²⁰ An increase in renewable energy generation is expected to reduce the overall cost of electricity and, with appropriate tariff settings, subsidies for WWO could be phased out.

16. **Policy reform.** Despite the challenges posed by COVID-19, the government remains committed to reform actions developed under the programmatic approach in making PPUC sustainable, including full cost recovery of business and capital and reliability and resilience of services based on an adequate regulatory framework. The reforms include actions completed under subprogram 1: (i) cost-reflective electricity tariffs and an awareness campaign and public hearings conducted on targeted subsidies for poor and low-income households, including those headed by women, have been completed; (ii) PPUC financial management has been strengthened by the adoption of financial modelling and the implementation of revenue-boosting actions for electricity operations; (iii) PPUC corporate governance has been strengthened, including through gender-sensitive human resource management procedures, flexible working arrangements and parental leave, and workplace harassment and discrimination policies (including on gender-based discrimination and sexual harassment); and (iv) market access for private sector participation in the energy sector improved and the first PPA to generate 20 megawatts of solar photovoltaic energy signed with a private developer.

17. Subprogram 2 focuses mostly on WWO tariff reforms (reform area 1), the remaining cross-sector reforms in financial management (reform area 2), and corporate governance (reform area 3). The actions contribute to the sustainability of WWO, which account for more than 70% of accounts receivable of PPUC and 72% of its cash deficit. All subprogram 2 policy actions have

¹⁸ IMF. 2018. *Article IV Review Mission to Republic of Palau*. Washington, DC.

¹⁹ Government of Palau. 2013. *Water Policy and Sanitation Master Plan, 2011–2036*. Ngerulmud.

²⁰ Government of Palau. 2019. *Palau Energy Roadmap*. Ngerulmud.

been completed.²¹ The actions will be further advanced under the post-program partnership framework (P3F).

18. **Reform area 1: Tariff reforms managed.** Justifiable, objective, and transparent regulation and tariff settings will build PPUC’s sustainability. The regulatory mandate of the Palau Energy and Water Administration (PEWA) was expanded to enable agency oversight of WWO tariffs and regulation through legislative amendments passed by the Olbiil Era Kelulau.²² Exercising its new regulatory mandate, PEWA has approved (i) regulations for setting of cost recovery tariffs for WWO and (ii) PPUC guidelines for WWO tariff petition. The new regulation will enable PPUC to generate sufficient revenue to cover its fixed and variable costs for WWO infrastructure and produce accountability and public justification for revenue targets. The new guidelines for tariff petition include procedures for (i) implementing a subsidy program for poor and low-income households, with clear and explicit instructions on types of subsidies, households’ eligibility criteria, and procedures to apply for allocated subsidies; (ii) conducting an awareness-raising campaign for poor and low-income households on the subsidy program, eligibility criteria, and how to apply for subsidized WWO services; and (iii) publicizing the existing grievance redress mechanism for receiving and resolving complaints from customers. To comply with the new regulations, PPUC has prepared and submitted its first WWO tariff petition to PEWA.

19. **Reform area 2: PPUC financial management enhanced.** The reforms aim to improve PPUC’s financial management through better performance monitoring and analytics integrated into corporate planning. The business analytics procedures approved by the PPUC board standardize monitoring and planning with industry standards. The procedures direct how PPUC prepares and discloses its cost allocation for energy and WWO. This action supports the government’s objectives for sustainable SOEs by providing a model of SOE financial management and performance disclosure. The PPUC board of directors approved WWO’s required corporate annual revenue model for FY2022–FY2024. The model, which is based on business analytics and cost allocation, supports PPUC’s revenue projections, i.e., the total amount of revenue required to recover WWO costs, which include prudent operation and maintenance costs as well as reasonable rates of return on debt and equity required to finance investments. To estimate the ability of tariffs to recover costs, the PPUC model compares total revenue with operating and capital costs in FY2022. The PPUC board of directors approved the PPUC’s revenue enhancement action plan, which prioritized high-value emergency actions to restore WWO sustainability.²³ The action plan is aligned with the PPUC investment plan for FY2022–FY2025.

20. **Reform area 3: PPUC corporate governance and transparency strengthened.** To comply with SOE reform objectives, the Ministry of Finance (MOF) started implementing performance monitoring policy and procedures for SOEs (including PPUC) based on the Organisation for Economic Co-operation and Development Guidelines for Corporate Governance of SOEs.²⁴ Implementing the policy and procedures allows MOF to undertake comprehensive and “arm-length” monitoring of SOE performance without jeopardizing the independence of SOE boards and operations. The expected results are (i) much higher levels of SOE performance transparency, (ii) comparability of performance indicators among SOEs and with industry benchmarks, and (iii) MOF’s enhanced ability to monitor SOEs’ public and commercial debt.

²¹ Policy actions of subprogram 2 were refined based on the accomplishments of subprogram 1 without any substantive changes to indicative policy actions.

²² Government of Palau. 2022. *House Bill No. 11-50-5S.HD1.SD1*. Ngerulmud.

²³ The emergency actions are replacement of (i) distribution pipelines with high technical losses in the Ngerkesewaol and (ii) old and inefficient water pumps at Ngerikiil and outlying states.

²⁴ Government of Palau. 2015. *Government State Owned Enterprise Policy Statement*. Ngerulmud.

21. To comply with MOF's SOE monitoring procedures, the PPUC board approved (i) its first statement of corporate intent (SCI) for 2021–2024, with annual key performance indicator targets to achieve corporate, operational, and financial sustainability; (ii) sustainable debt management procedures strengthening resilience to external shocks by optimizing PPUC's capital structure and borrowings; and (iii) PPUC's board nomination and integrity procedures. The SCI is a key public accountability document of PPUC creating greater public confidence in SOE operations and targets, which has been disclosed on PPUC's website. The debt management procedure will ensure that PPUC has an effective mechanism to originate, manage, and disclose its liabilities in compliance with international financial reporting and audit standards.²⁵ As PPUC's ability to borrow is highly dependent on government support, the debt management procedure sets formal targets for capital structure and debt ceilings consistent with SCI approved by the PPUC board. Finally, board nomination and integrity procedures will ensure a transparent and equitable board selection process by providing a specific skills-based director selection and appointment process. The PPUC board will undertake a skills-gap analysis by first assessing the skills that the board requires, then identifying existing board skills, and finally developing terms of reference to fill skills gaps. The document includes procedures to train new directors, identify and manage conflicts of interest, and implement the Code of Corporate Governance adopted under subprogram 1.

22. **Reform area 4: Market access for private sector participation in energy sector improved.** The MOF approved disclosure procedures for PPPs, including energy PPPs, to strengthen market confidence that signed PPAs are based on justifiable, objective, and transparent criteria. The procedures enable the MOF to efficiently manage fiscal risks from SOEs' contingent liabilities under PPP transactions compliant with international best practice.²⁶ The PPUC board approved a least-cost power generation and transmission enhancement plan for FY2022–FY2025 to phase out depreciated assets and prioritize renewable energy evacuation compliant with PPUC's capacity plan approved under subprogram 1 and Palau's commitment under the Paris Agreement and United Nations Sustainable Development Goals 13.²⁷ The plan is harmonized with PPUC budgets and augmented with national renewable targets.

23. **Sustainability of reforms.** The P3F has been formulated to further strengthen the sustainability of the program's reforms. The P3F will focus on evaluating improvements in tariffs, PPUC sustainability, and governance to help the government achieve the SOE performance targets. For reform area 1, the P3F will focus on monitoring and assistance in (i) implementation of cost-reflective tariffs for WWO and energy power operations, and (ii) public awareness and implementation of targeted social assistance programs for vulnerable consumer groups. For reform area 2, the P3F will support PPUC financial management and sustainability through assistance in updating SCI and SOE performance monitoring and disclosure reports by MOF. For reform area 3, the P3F will monitor PPUC compliance with corporate governance standards and disclosure of its performance and activities. The P3F will evaluate PEWA progress in achieving renewable energy and private sector investment targets. ADB will be providing capacity-building support to PEWA and PPUC to sustain reform objectives consistent with national objectives. Activities under ADB technical assistance (TA) are aligned with the P3F (footnotes 28–30).

24. **ADB value addition.** ADB has added value to all actions under subprogram 2 through TA projects and staff advisory support.²⁸ ADB has a history of involvement in SOE reforms in Palau

²⁵ PPUC will be reporting its loan covenants as part of its annual audited statements.

²⁶ World Bank Group. 2017. *Framework for Disclosure in Public–Private Partnership Projects*. Washington, DC.

²⁷ Paris Agreement. Signed and ratified on 22 April 2016.

²⁸ ADB. 2020. *Technical Assistance to the Republic of Palau for the Palau Public Utilities Corporation Reform*. Manila; and ADB. 2019. *Technical Assistance for Pacific Private Sector Development Initiative, Phase IV*. Manila.

supporting (i) an MOF capacity-building program to improve SOE corporate planning, performance monitoring, and reporting; (ii) institutional and regulation planning for SOE corporate reforms; and (iii) creation of PPP transparency and disclosure standards.²⁹ ADB TA projects helped the government (i) prepare WWO tariff and regulatory reforms and create a single utilities regulation agency, including capacity building; (ii) handle PPUC's financial management and governance; and (iii) develop and implement gender and social safeguards. ADB has supported the National Development Bank of Palau to boost its gender-inclusive renewable energy lending, financial management, and internal audit reforms.³⁰ ADB has an ongoing parallel policy-based operation supporting broader public financial management reforms—including by reducing fiscal risks from weak management of public revenue, expenditure, and liabilities—aligned with the program's focus on improving PPUC's financial sustainability.³¹

25. **Lessons.** Lessons from ADB operations in Palau suggest that (i) sufficient TA resources must be allocated to support reforms given shortages and/or high turnover of qualified staff, and (ii) reform programs require more comprehensive dialogue with government stakeholders to ensure that agreed reforms can be implemented in a changing political environment.³² ADB's subprogram 1 experience confirms the importance of strong and high-level government ownership and commitment to tackling cross-sector and cross-ministry issues of SOE reforms. The coordination of multiple stakeholders and a clear delineation of roles and responsibilities are crucial to reform tariff regulation. Public awareness of available targeted social assistance to low-income and vulnerable households is important for reforms to have an impact. The reform process needs to be reasonably flexible to accommodate a longer-term horizon of tariff regulations, which makes a programmatic approach a suitable tool to support the government's medium- and long-term efforts. The program draws upon lessons and recommendations from a 2018 report by ADB's Independent Evaluation Department on SOE reforms in ADB developing member countries, including lessons related to supporting government oversight mechanisms for SOEs and governance risks.³³

26. **Development partner coordination.** ADB collaborated with the International Monetary Fund (IMF) on program design and policy reforms implementation under subprogram 2 to ensure (i) alignment of Palau's macro-fiscal framework assessment and prospects for post-COVID-19 recovery, and (ii) PPP transparency legislation piloted by Palau and the MOF's fiscal risk management capacity development. The IMF's assessment confirms that the program would not adversely impact the country's debt sustainability and would help Palau contain quasi-fiscal risks and support long-term fiscal sustainability.³⁴

C. Expected Outcome of the Reforms

27. The program is aligned with Palau's development objectives: (i) SOE sustainability, including full cost recovery of business and capital, achieved; and (ii) reliability and resilience of utility services improved based on an adequate regulatory framework and tariffs (footnote 25). Improving PPUC's sustainability and increasing the reliability of WWO services will bring

²⁹ ADB. 2019. *Technical Assistance for Pacific Private Sector Development Initiative, Phase IV*. Manila.

³⁰ ADB. 2020. *Technical Assistance to the Republic of Palau for Disaster Resilient Clean Energy Financing*. Manila.

³¹ ADB. 2021. [Recovery through Improved Systems and Expenditure Support Program](#). Manila.

³² ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Palau for the Water Sector Improvement Program*. Manila.

³³ Independent Evaluation Department. 2018. *State-Owned Enterprise Engagement and Reform*. Manila: ADB.

³⁴ IMF. 2021. *Article IV Review Mission to Republic of Palau*. Washington, DC. International Monetary Fund Article IV Report (accessible from the list of linked documents in Appendix 2). The IMF confirmed on 23 March 2022 that the attached IMF Article IV Report for the Republic of Palau may serve as the IMF assessment letter.

efficiency savings, health benefits, and associated benefits. With the program, the policy actions enable PPUC to improve financial and operational efficiencies, resulting in the ability to invest in reducing technical losses (savings from water treatment expenses and electricity cost for water pumping) and improve the quality of services. With an approved revenue enhancement action plan, PPUC will prioritize its investment projects to reduce losses and improve the quality of water supplied in outlying states, with substantial health benefits. With an approved least-cost generation and transmission plan, PPUC can phase out depreciated assets and prioritize power evacuation of affordable and cheaper supply from IPPs, replacing fossil fuel–based generation. The subprogram will contribute to budgetary headroom through avoided subsidies to WWO, enabling the government to invest in critical areas with significant and positive impacts on economic growth and employment. The savings may allow Palau to redirect resources to tackle other pressing issues, including the COVID-19 response.³⁵

D. Development Financing Needs and Budget Support

28. The continuing impacts of COVID-19 disruptions are expected to result in large near-term financing needs, projected at a total of \$39.9 million in FY2022–FY2023 (Table 2). To support increasing development needs and help meet the costs of implementing reforms, the government has requested a concessional loan of \$5 million from ADB’s ordinary capital resources to help finance subprogram 2.³⁶ Along with the parallel program supporting broader public financial management and private sector development reforms, ADB’s pipeline budget support totals \$35 million in FY2022.³⁷ Although FY2022 financing needs are provisionally estimated at \$30.6 million, they are subject to significant uncertainties and downside risks, including cost escalations because of elevated oil prices stemming from the Russian Federation invasion of Ukraine as well as any delays in the anticipated tourism recovery during the latter half of the fiscal year. Under the current highly uncertain environment, FY2022 financing needs are likely to increase to \$55 million if the impacts of high inflation and delayed tourism recovery are fully realized.³⁸

29. The loan will have a 25-year term, including a grace period of 5 years; an interest rate of 2.0% per year during the grace period and thereafter; and such other terms and conditions set forth in the draft loan agreement. Although the loan will inevitably lift the public debt ratio in the immediate term, it will not undermine its downward trend over the longer term. The loan will not add significantly to the annual debt service obligations facing the government.

³⁵ Program Economic Assessment (accessible from the list of linked documents in Appendix 2).

³⁶ Climate mitigation is estimated at US\$770,000 based on relevancy of policy actions 2.13 and 2.14.

³⁷ ADB. 2022. *Proposed Policy-Based Loan for Subprogram 2 for Recovery through Improved Systems and Expenditure Support Program* (for processing).

³⁸ According to ADB’s estimates, a higher inflation environment can expand public expenditures from the IMF’s estimate of \$25.7 million to about \$37.1 million. The IMF’s deficit projection involves an underlying assumption that visitor arrivals would reach more than 24,000 during FY2022. With arrivals in the first half of the fiscal year at only about 3,400, second-half arrivals would need to reach about 47% of FY2019 (pre-pandemic) levels for the full-year projection to be realized. If visitor arrivals fall short—and reach only about the midpoint of the 8% of FY2019 monthly arrivals recorded in the first half of FY2022 and the IMF’s projected levels—fiscal year total arrivals would only be less than 16,000. Hence, the result would be a reduction in FY2022 tax revenue collections from the IMF’s projected \$34.8 million to \$22.0 million, a shortfall of \$12.8 million.

Table 2: Development Financing Needs, FY2019–FY2022

Item	FY2020		FY2021e		FY2022p		FY2023p	
	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)
Revenues	122.1	47.4	100.1	46.3	100.1	41.2	112.0	38.0
Tax and nontax	61.8	24.0	47.8	22.1	49.2	20.3	67.5	22.9
External grants	60.3	23.4	52.3	24.2	50.9	21.0	44.5	15.1
Expenditures	150.3	58.3	142.3	65.8	130.7	53.9	121.3	41.1
Fiscal balance	(28.2)	(10.9)	(42.2)	(19.5)	(30.6)	(12.6)	(9.3)	(3.2)
Financing needs	28.2	10.9	42.2	19.5	30.6	12.6	9.3	3.2
Government deposits	(6.8)	(2.6)	12.2	5.6	(4.4)	(1.5)	4.4	1.5
ADB CDF	15.0	5.8						
ADB HEALS	20.0	7.8						
ADB PPUC			5.0	2.3	5.0	2.1		
ADB RISES			25.0	11.6	30.0	12.4		
Other: TBD							4.9	1.7
Nominal GDP	257.7		216.2		242.7		294.9	

() = negative, ADB = Asian Development Bank, CDF = contingent disaster financing, e = estimate, FY = fiscal year, GDP = gross domestic product, HEALS = health expenditure and livelihoods support, p = projection, PPUC = Palau Public Utilities Corporation, RISES = recovery through improved systems and expenditure support, TBD = to be determined.

Notes: The ADB CDF and HEALS programs supported the Coronavirus Relief One-Stop Shop Program until September 2021. Excess funds were deposited in FY2020 (hence the negative financing entry) for use in FY2021. Similarly, a portion of ADB's FY2022 budget support will be deposited by the government for subsequent partial financing of the FY2023 deficit.

Sources: International Monetary Fund. 2021. Republic of Palau: 2021 Article IV Consultation—Press Release; staff report; and Statement by the Executive Director for the Republic of Palau. *IMF Country Report No. 21/263*. Washington, DC; and Asian Development Bank estimates.

30. **Debt sustainability.** Palau's public debt is mostly external, with domestic debt equivalent to only 4.7% of GDP as of FY2019. External public debt fell gradually from the equivalent of 38.3% of GDP in FY2009 to 23.1% in FY2015, before rising to 33.9% by FY2019 amid infrastructure investments in information and communication technology and in water supply and sanitation supported by ADB (footnote 10). The onset of the COVID-19 crisis pushed the public debt–GDP ratio to 62.1% in FY2020 and to 85.7% in FY2021. Although a further rise in the public debt–GDP ratio to a peak of 90.3% in FY2022 is projected, the IMF's December 2021 debt sustainability analysis shows that debt will maintain a steady downward trend in the medium term as the economy recovers. With sustained recovery, the public debt–GDP ratio can gradually fall back to the FY2020 level by FY2026, reverting to below the pre–COVID-19 level in succeeding years, even under conservative economic growth assumptions. While total projected borrowing during FY2021 and FY2022 will add to debt service obligations, the program's support for containing fiscal risks from the largest SOE will help ensure that contingent liabilities are minimized. The IMF concluded that public debt remained sustainable and fiscal vulnerabilities contained (footnote 34).

E. Implementation Arrangements

31. The MOF is the program's executing agency and responsible for overall program monitoring and reporting. The PPUC and PEWA will be the implementing agencies. A program steering committee, chaired by the minister of finance and comprised of senior officials from PEWA and the PPUC board, meets on a regular basis to review progress in implementing the reforms. The implementation period is November 2020–April 2022 for subprogram 2. The proceeds of the policy-based loan will be withdrawn in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).³⁹

³⁹ List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

III. DUE DILIGENCE

32. **Safeguards.** Following ADB's Safeguard Policy Statement (2009), subprogram 2 is classified as category C for the environment, involuntary resettlement, and indigenous peoples. Prior policy actions have been assessed and are not expected to result in or lead to involuntary resettlement or negatively affect indigenous peoples or the environment.

33. **Poverty and social.** Improving PPUC's performance and WWO's reliability under subprogram 2 will build upon the success of subprogram 1, bringing efficiency savings, health benefits, and associated benefits to the poor and vulnerable. The continued focus on facilitating a more robust and accountable tariff-setting process will ensure that the cost of operations is covered while setting transparent procedures for implementation of a more effective subsidy program for poor and low-income households. Subprogram 2 will restore public confidence in tariff setting and increase public awareness of eligibility and application procedures. The implications in the context of a post-COVID-19 environment are significant as increased efficiencies will reduce subsidies to PPUC and allow resources to be better spent in other economically productive places, including recovery efforts such as job creation and programs to better protect the poor and most vulnerable.

34. **Gender.** The program is categorized as *effective gender mainstreaming*. Proactive gender measures include ensuring that tariff reform meets the needs of women and girls and that actions are taken for gender-responsive capacity development for PPUC. A gender-inclusive awareness-raising campaign on the subsidy, requirements, and application process will help women better access subsidies (as many poor or low-income women are often unaware of the program or eligibility criteria). PPUC's board approved a gender-sensitive SCI and performance indicators, including promotion of gender equality within PPUC and activities to support more women in skilled, technical, and nontraditional roles and in management and leadership positions.⁴⁰ PPUC will continue implementing its corporate gender strategy (2020–2023) and gender-responsive human resource procedures, including formal provisions for flexible working arrangements, prevention of bullying, gender-based discrimination, and sexual harassment. PPUC's board approved a gender-responsive capacity development plan, including the preparation of the training plan that targets women, with annual budget provision. Finally, PPUC will continue implementing its code of corporate governance, including a quota (30%) for women board members.⁴¹

35. **Governance.** Palau has made considerable progress in improving the legal and regulatory framework for public financial management, with transparent accounting, budgeting, and auditing systems in place. The public budget documents present the basic and supplementary information required to support transparency of funds flow. The financial statements of all SOEs, including PPUC, are compliant with Generally Accepted Accounting Principles reporting standards and have been audited since 2010. To strengthen PPUC's fiscal risk management, the government mandated PEWA to monitor PPA terms and conditions consistent with PPUC offtake capacity. The subprogram institutes improved governance mechanisms that remain in effect through political changes. Public expenditure and debt monitoring is integrated into the public budget management system. Major risks and mitigating

⁴⁰ Conduct of public information on subsidy provision for communities and households. Corporate indicators that highlight gender-disaggregated targets, particularly for women staff and partner institutions, including secondary schools.

⁴¹ As of January 2022, PPUC had two women out of seven members of the supervisory board.

measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.⁴²

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigation Measures
Prolonged COVID-19 pandemic and/or other external shocks aggravate economic and fiscal pressures.	The MOF continues its comprehensive recovery measures, such as (i) gradual winding back of fiscal stimulus measures, (ii) social safety net programs, and (iii) enhanced health protocols and a vaccination program. The post-program partnership framework will help sustain the policy dialogue and PPUC reform momentum toward economic recovery in 2023.
Legal and regulatory framework for compliance and performance monitoring of state-owned enterprises is inadequate.	Continuous and long-term engagement by the Asian Development Bank with the MOF will reform the legal and regulatory framework for compliance and performance monitoring of state-owned enterprises, including PPUC. The post-program partnership framework will help sustain the ongoing policy dialogue on the MOF's capacity for performance monitoring.
Institutional accountability and audit capacity in the public sector, including monitoring of contingent liabilities, are insufficient.	The MOF updates fiscal responsibility legislation, the medium-term budget strategy, and the external debt management strategy. The Palau Energy and Water Administration is mandated to monitor power purchase agreements with independent power producers, reconciling their terms with PPUC's financial position and capacity.

COVID-19 = coronavirus disease, MOF = Ministry of Finance, PPUC = Palau Public Utility Corporation.
Source: Asian Development Bank.

36. Integrity due diligence was conducted on PPUC, members of its board of directors, and senior management.⁴³ It has been confirmed that they do not pose potentially significant integrity risk or risks relating to money laundering or terrorism financing in the project jurisdiction. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government, PEWA, and PPUC.

IV. ASSURANCES

37. The government and PPUC have assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement, as described in detail in the draft loan agreement.

V. RECOMMENDATION

38. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$5,000,000 to the Republic of Palau for subprogram 2 of the Palau Public Utilities Corporation Reform Program, from ADB's ordinary capital resources, in concessional terms, with an interest charge at the rate of 2% per year during the grace period and thereafter; for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Masatsugu Asakawa
President

8 July 2022

⁴² Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

⁴³ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

POLICY DESIGN AND MONITORING FRAMEWORK

Country's Overarching Development Objective			
State-owned enterprise sustainability, including full-cost recovery of business and capital, achieved Reliability and resilience of utility services improved based on adequate regulatory framework and tariffs ^a			
Outcome PPUC's financial sustainability improved		Risks and Critical Assumptions R: Poor coordination between government departments limits reform effect. R: Prolonged coronavirus disease pandemic and/or other external shocks aggravate economic and fiscal pressures	
Prior Actions: Subprogram 1 Completed (May 2020–October 2020)	Prior Actions: Subprogram 2 Completed (November 2020–April 2022)	Outcome Indicators	Post-Program Partnership Framework
Reform Area 1: Tariff reforms managed			
1.1. PEA adopted regulation for setting electricity tariffs.	2.1. Palau National Congress (Olbiil era Kelulau) approved legislative amendments which came into effect on 24 March 2022 to expand PEWA's mandate to include oversight over WWO tariff settings and regulations. ^b	By 2023 a. Cost-recovery tariff operationalized for electricity and water and wastewater operations (2019 baseline: Tariff increase prohibited) (Source: PPUC annual report)	MOF and PEWA monitor the implementation of new electricity and WWO regulations and tariffs to ensure the sustainability of PPUC.
1.2. PEA adopted the guidelines for electricity tariff petition, including subsidy and awareness raising procedures for poor and low-income households and/or households headed by women.	2.2. PEWA approved regulations for setting cost recovery WWO tariffs for PPUC, including subsidy and awareness raising procedures for poor and low-income households (including female headed households) helping consumers to be able to plan utility expenses, which became effective on 6 April 2022.		
1.3. PPUC Board approved electricity tariff petition, including subsidy and awareness-raising procedures for poor and low-income households and/or households headed by women.	2.3. PEWA approved the guidelines for WWO tariff petition, including subsidy and awareness raising to create a transparent and predictable petition process for PPUC, which became effective on 6 April 2022.		

Prior Actions: Subprogram 1 Completed (May 2020–October 2020)	Prior Actions: Subprogram 2 Completed (November 2020–April 2022)	Outcome Indicators	Post-Program Partnership Framework
	2.4. PPUC Board approved WWO tariff petition to restore PPUC WWO financial sustainability through cost recovery tariff and submitted it to PEWA on 7 April 2022.		
Reform Area 2: PPUC financial management enhanced			
1.4. PPUC Board adopted PPUC’s revenue required model for electricity operations.	2.5. PPUC’s Board approved PPUC’s annual revenue required model for WWO financial planning for FY 2022-2024 which became effective on January 2022. ^c		MOF and PEWA monitoring of PPUC financial and operational performance and risks.
1.5. PPUC Board approved revenue enhancement action plan for PPUC for 2021.	2.6. PPUC’s Board approved PPUC’s revenue enhancement action plan on 27 January 2022 to restore sustainability in WWO operations which will commence implementation from FY2023. ^d		
1.6. PPUC Board approved GAAP-compliant accounting policy and procedures.	2.7. PPUC’s Board approved PPUC’s business analytics procedure that provides detailed guidance on cost allocation and analysis and its performance disclosure framework for electricity and WWO effective from 18 August 2021, to enhance quality of management decisions and resource planning.		
Reform Area 3: PPUC corporate governance and transparency strengthened			
1.7. PPUC Board adopted Code of Corporate Governance for PPUC based on 2015 OECD Corporate Governance Guidelines for SOEs including 30% quota for women board members.	2.8. MOF commenced implementation of SOE performance monitoring policy and procedures for SOEs, (including PPUC) effective from 20 October 2021 to undertake performance and operations monitoring of SOEs. ^e	b. PPUC corporate performance disclosure operationalized (2019 baseline: no annual public disclosure) (Source: PPUC	ADB and MOF monitoring of SOEs (including PPUC) and evaluates financial and operational performance and risks.
1.8. PPUC Board adopted procedures for audit, risk and compliance management.	2.9. PPUC’s board approved PPUC statement of corporate intent in August 2021 which sets out its		

Prior Actions: Subprogram 1 Completed (May 2020–October 2020)	Prior Actions: Subprogram 2 Completed (November 2020–April 2022)	Outcome Indicators	Post-Program Partnership Framework
	corporate, operational, and financial sustainability goals for FY2021-2024, with annual KPI targets including the increase in the number of women in management and technical roles, and delivery of programmatic capacity building (with targets for training to women). ¹	annual statement of corporate intent)	
1.9. PPUC Board adopted PPUC's gender strategy for PPUC.	2.10. PPUC's Board approved PPUC's sustainable debt management procedure effective from August 2021 which sets formal targets for capital structure and debt ceilings consistent with SCI approved by the PPUC board to enhance corporate resilience to external shocks.		
1.10. PPUC's Board implemented gender-sensitive procedures, including flexible working arrangements, introduction of parental leave and workplace harassment and discrimination policies (including gender-based discrimination and sexual harassment).	2.11. PPUC's board approved procedures for PPUC's board nomination and integrity and PPUC staff capacity development and training procedures and budget including training targets for women effective from August 2021.		

Prior Actions: Subprogram 1 Completed (May 2020–October 2020)	Prior Actions: Subprogram 2 Completed (November 2020–April 2022)	Outcome Indicators	Post-Program Partnership Framework
Reform Area 4: Market access for private sector participation in energy sector improved			
1.11. PEA approved the regulations for development of renewable energy facilities by IPPs.	2.12. PPUC board approved the least-cost generation and transmission enhancement plan on 28 February 2022 for the period from FY2022–2025 to phase out depreciated assets and prioritize renewable energy evacuation. ⁹	c. Share of private sector participation in power generation in capacity terms increased to at least 20% (2020 baseline: 5%) (Source: PPUC annual report)	MOF and PEWA monitoring of PPUC commitments in achieving national renewable energy targets.
1.12. PEA approved PPUC's capacity plan.	2.13. MOF approved disclosure procedures for new PPPs (including energy and water sectors) effective from 3 September 2021 to manage sovereign fiscal risks through enhanced transparency of PPP transactions and disclosure of key terms and conditions.		
Budget Support			
ADB: \$5 million (concessional ordinary capital resources loan)			

ADB = Asian Development Bank, GAAP = generally accepted accounting principles, IPP = independent power producer, KPI = key performance indicator, MOF = Ministry of Finance, OECD = Organisation for Economic Co-operation and Development, PDMF = policy design and monitoring framework, PEA = Palau Energy Administration, PEWA = Palau Energy and Water Administration, PPP = public-private partnership, PPUC = Palau Public Utilities Corporation, R = risk, SOE = state-owned enterprise, WWO = water and wastewater operations.

^a The Republic of Palau. 2015. *State Owned Enterprise Policy Statement*. Palau.

^b This policy action is revised from government approval to approval by the legislature to align the existing legislative framework for energy sector regulation with WWO sector regulation. Under the new mandate, PEWA (formerly Palau Energy Administration) became a single regulator for energy, water and wastewater services and will be applying cost-reflective tariff methodologies and procedures.

^c The revenue required model is created to estimate the amount of revenue required to recover PPUC's WWO cost, where such costs include operation and maintenance costs and rates of return on debt and equity required to finance investments. The WWO model is adopted by PPUC, and tariff petition (PA 1.3) is prepared based on model scenarios and projections.

^d Revenue enhancement actions (investments) for WWO have been included into government's annual expenditure plan for 2023.

^e SOE performance monitoring policy and procedures introduce corporate management principles for public utility services and operations based on cost recovery principles and consistent with international best practice. For example, MOF will require SOEs to submit annual key performance indicators with benchmarks and comparative analysis.

^f PPUC has established a project team in charge of SCI targets' planning, review and reporting to management and board.

⁹ PPUC, assisted by ADB TA, completed its first least-cost generation and transmission analysis and prepared a list of urgent investment projects to achieve the country's renewable energy targets. The plan includes grid upgrade project for power evacuation from solar IPP and proposed for ADB and JICA financing.

Contribution to Strategy 2030 Operational Priorities: Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=54151-003-3>

1. Loan Agreement
2. Sector Assessment (Summary): Multisector
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Article IV Report¹
6. Summary Poverty Reduction and Social Strategy
7. Program Economic Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items
10. Potential Safeguards Impacts of Policy Reforms
11. Approved Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 and Technical Assistance Grant to the Republic of Palau for the Palau Public Utilities Corporation Reform Program (Subprogram 1)

Supplementary Documents

12. Country Economic Indicators: Palau
13. Fiduciary Assessment

¹ The International Monetary Fund confirmed on 23 March 2022 that the attached IMF Article IV Report for the Republic of Palau may serve as the IMF assessment letter.

DEVELOPMENT POLICY LETTER



KALEB UDUI, JR.
Minister

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8 April 2022
Serial No. MOF-2022-083

Mr. Masatsugu Asakawa
President
Asian Development Bank

Re: Development Policy

Dear Mr. President,

On behalf of the Republic of Palau (ROP) I would like to express appreciation to Asian Development Bank (ADB) for its strong and continued support to Palau's development efforts and energy reforms in recent years.

This development policy letter signifies our interest in obtaining \$5 million loan under proposed Palau Public Utilities Corporation Reform Program - Subprogram 2 to meet ROP's objectives in SOE reforms to improve PPUC performance and sustainability consistent with Palau State Owned Enterprise Policy Statement (2015).

Palau is committed to mobilize private investments interested in commercially viable renewable energy and water and wastewater services. Strong and financially healthy Palau Public Utilities Corporation (PPUC), acting as a market off-taker, is a prerequisite for private sector participation in utility service development and supply. Improved corporate governance and financial management of PPUC will have far-reaching effects on the day-to-day lives of Palau's citizens and the business sector. With unprecedented challenge presented by COVID-19 global pandemic to our government and people of Palau, PPUC reform remains vital to the security and reliability of electricity, water, and sewerage services that are essential to sustain Palau's public goods and the health of the nation.

PPUC's sustainability is severely affected by lack of reforms and investments into water and sanitation sector. Until recently, there was no designated oversight agency for the sector and the government undertook the combined functions of planning, investment, and regulation directives. Inadequate regulatory environment and oversight of water and wastewater operations (WWO) led to significant inefficiencies and liquidity gap at PPUC. With no prudent and transparent tariff setting PPUC WWO has not been able to recover costs of service and resulted in low public confidence in the utility services. There has not been comprehensive corporate monitoring of key performance indicators and resource planning. These weaknesses contribute to operational inefficiencies and negative liquidity at PPUC WWO. Financial limitations also lead to a shortage of equipment resulting in inadequate controls to ensure safe drinking water supplies at the user end and increasing water losses in the distribution system. Going forward, PPUC's WWO reforms will contribute to sector recovery and sustainability of the utility's services in Palau consistent with national development targets.



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Addressing the challenges faced by PPUC requires our joint collaborative leadership, adequate institutional arrangements, common goals, and a shared reform vision and strategy.

Reform Program and Development Finance

To comply with its reform objectives, the ROP completed its policy actions under four areas of reforms agreed under Palau Public Utilities Corporation Reform Program.

Reform Area 1: Tariff reforms.

The President of the ROP signed into law (Republic of Palau Public Law No. 11-18) to vest authority in Palau Energy and Water Regulation Administration (PEWA, formerly Palau Energy Administration) to enable its oversight in water and wastewater operations (WWO) tariff settings and regulations. Under new mandate, PEWA has approved (ii) regulations for setting of cost recovery WWO tariffs; and (ii) guidelines for WWO tariff petition by PPUC. Without a designated oversight agency for the sector, the government undertook the combined functions of planning, investment, and tariff directives that compromised PPUC's ability to operate on full cost recovery principles. The new regulation enables PPUC to generate sufficient revenue to cover its fixed and variable costs for WWO infrastructure development and maintenance.

To comply with the new regulation, PPUC board prepared and submitted a WWO tariff petition by PPUC for PEWA's review and approval.

Reform Area 2: PPUC financial management.

To comply with industry standards, PPUC's financial management efficiency have been enhanced significantly through performance and business analytics approved by PPUC Board and integrated into PPUC corporate and resource planning systems. The new business analytics procedures will standardize PPUC's performance monitoring and planning with industry requirements. The action helps support the ROP's objectives for sustainable SOEs, by providing a model of SOE financial management for the remaining three SOEs in Palau.

The PPUC Board also approved the required corporate annual revenue model for WWO during 2022–2025 financial years harmonized with the ROP annual national budget and capital investment plans. Similar to energy revenue planning model under Subprogram 1, this model will support PPUC's financial projections based on its revenue requirements—i.e., the total amount of revenue required to recover its costs of WWO, where such costs include prudent operation and maintenance costs and reasonable rates of return on debt and equity to finance capital investments. This model facilitates PPUC's capability to project its tariffs, financial position and risks.

The PPUC Board also approved PPUC's revenue enhancement action plan prioritizing high-value emergency actions to restore PPUC's WWO sustainability. These actions include (i) reducing losses in water supply system; (ii) replacing old and inefficient water pumps; and (iii) rehabilitation of pump



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stations and water quality improvements at reservoirs. The identified high priority investment projects are considered as “quick wins” for improving PPUC’s liquidity by reducing losses and improving quality of water supply and sanitation service. The action plan is aligned with PPUC WWO annual investment plan for 2022–2025.

Reform Area 3: PPUC corporate governance and transparency

To comply with the Palau SOE Policy Paper (2015), the ROP adopted SOE performance monitoring policy and procedures for SOEs and operationalized its SOE unit and monitoring function under the Ministry of Finance (MOF) to supervise all SOEs (including PPUC) activities and sustainability. This action supports the MOF to (i) introduce first in its kind SOEs performance transparency, (ii) SOEs’ performance indicators consistent with industry benchmarks; (iii) enhance SOEs fiscal risk management based on IMF policy recommendation under Article IV Review Mission (2021).

We confirm that this monitoring function under the MOF complies the Organization for Economic Co-operation and Development Guidelines for Corporate Governance of SOEs and does not undermine SOEs’ Board independence and activities.

To comply with ROP requirements, PPUC Board approved (i) comprehensive and timebound procedures for preparation of its first statement of corporate intent (SCI) with annual KPI targets to achieve corporate, operational and financial sustainability; (ii) sustainable debt management procedure for optimized capital structure and investments; and (iii) PPUC’s Board nomination procedure. The ROP expects that these actions will be resulted in (i) much higher levels of SOEs performance transparency, (ii) comparability of performance indicators among SOEs and with industry benchmarks; (iii) MOF’s enhanced ability to monitor SOEs public and commercial debt.

Under the new procedure, the SCI becomes a key public accountability document of PPUC creating greater public confidence in SOE’s operations and targets. The debt management procedure will ensure that PPUC has an effective mechanism to originate, manage and disclose its liabilities in compliance with international financial reporting and audit standards. As PPUC’s ability to borrow is highly dependent on government support, the debt management procedure sets formal targets for capital structure and debt ceilings consistent with SCI.

Finally, the PPUC board has adopted board nomination procedures to ensure a transparent and equitable board selection process by providing a specific skills-based director selection and appointment process. According to the new procedure, PPUC will undertake a skills-gap analysis by first assessing the skills that the board requires, then identifying existing board skills, and finally developing terms of reference to fill skill-gaps. This document provides comprehensive guidance on (i) new directors training and capacity building activities required; (ii) identification and managing conflicts of interest and implementation of the Code of Corporate Governance adopted by PPUC in 2020.



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Reform Area 4: Improving market access for private sector participation in renewable energy

The COVID-19 pandemic has resulted in unprecedented level of public borrowing and the Government recognizes urgency of reforms to improve market access for private sector participation in capital intense utility services such as energy, water and wastewater services.

To enhance access and competition, the ROP approved disclosure procedures for PPPs to strengthen market confidence that signed PPP transactions are based on justifiable, objective and transparent criteria.

We are very proud to acknowledge that **Palau is the first among ADB developing member countries championing PPP disclosure standards consistent with the World Bank's Framework for Disclosure in PPPs (2016).**

We firmly believe that this procedure will enable the MOF to efficiently manage fiscal risks from SOEs' contingent liabilities under negotiated and signed PPP transactions.

To improve capital planning, PPUC Board approved a least cost power generation and transmission enhancement plan for 2022-2025 to phase out depreciated assets and prioritize renewable energy evacuation compliant with PPUC's capacity plan approved in 2022.

Let me reassure that we remain committed to the implementation of the PPUC reforms. We also confirm that the policy actions proposed under this program are reflective and fully in consonance with the reform agenda of ROP.

The proposed financing of \$5.0 million under subprogram 2 Palau Public Utilities Corporation Reform Program is very timely and will help cover 16.3% of the government's FY2022 gross financing requirements projected at a total of \$30.6 million (equivalent to 12.6% of GDP), which have remained elevated due to the ongoing COVID-19 crisis.

On behalf of the ROP, we would like to thank ADB for working closely with my government in developing this program and would like to reiterate our full support for it.

We are committed to continuing our collaboration with ADB under the post-program partnership framework (PPPF) to further strengthen the sustainability of SOE reforms initiated under this Program. We will continue our efforts in (i) monitoring regulation reforms by PEWA and sustaining cost-reflective tariffs for PPUC (ii) guiding public awareness and targeted social assistance programs for vulnerable consumer groups. The MOF will evaluate PPUC financial management and sustainability through its audited annual statements and other performance disclosure reports. Also, the MOF will monitor PPUC's compliance with corporate governance standards and disclosure of its KPI targets and activities. Lastly, we will support PEWA and PPUC in achieving the country's renewable energy and private sector investment targets for 2022-2024.



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This cooperation with ADB under Subprogram 2 and PPPF will help ROP to expedite and sustain reforms for a favorable legal and institutional infrastructure leading to post-COVID-19 pandemic recovery and growth and achieving Palau's renewable energy targets and SOE reform objectives.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Kaleb Udui, Jr.', is written over a horizontal line.

Kaleb Udui, Jr.
Minister