

ASIAN DEVELOPMENT BANK

TAR: TON 36376

**TECHNICAL ASSISTANCE
TO THE
KINGDOM OF TONGA
FOR THE
RATIONALIZATION OF PUBLIC ENTERPRISES**

May 2003

CURRENCY EQUIVALENTS

(as of 20 March 2003)

Currency Unit	–	Pa'anga (\$T)
T\$1.00	=	\$0.4919
\$1.00	=	T\$2.0329

ABBREVIATIONS

ADB	–	Asian Development Bank
EPSRP	–	Economic and Public Sector Reform Program
GIU	–	Government Investment Unit, Ministry of Finance
MOF	–	Ministry of Finance
NZAID	–	New Zealand Agency for International Development
TA	–	technical assistance

NOTES

- (i) In this report, \$ refers to US dollars.
- (ii) 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., FY2001 ends on 30 June 2001.

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I. INTRODUCTION

1. During the 2002 Country Programming Mission, the Government of Tonga requested support from the Asian Development Bank (ADB) for a technical assistance (TA) to speed up the reform process of government commercial activities, especially public enterprises. The reform is an important element of the comprehensive economic and public sector reform program (EPSRP) initiated in 2001.

2. The EPSRP has been supported by multilateral and bilateral aid agencies, including ADB. ADB provided a program loan of \$10 million in support of reform measures in public finance and the public service.¹ Some assistance has been provided by New Zealand Agency for International Development (NZAID)² in recent years to create a database of public enterprise financial information and to conduct ad hoc reviews. The Government, however, wished to accelerate reforms in state-owned enterprises to reduce the increasing subsidy burden on the budget and, where appropriate, to transfer some of these enterprises and activities to the private sector. The TA was included in the approved 2002 country strategy program update (CSPU).³ The initial fact-finding mission was carried out from 2 to 5 December 2002. The Government confirmed the rationale and scope of the TA. The TA framework is presented in Appendix 1.⁴

II. ISSUES

3. The initiation of the comprehensive EPSRP in 2001 was the result of extensive policy dialogue between the Government and ADB since 1998. The EPSRP aims to enhance private-sector-led economic growth by (i) promoting policies that create an environment conducive to increased investment and employment by the private sector, and (ii) improving the efficiency and effectiveness of service delivery by the public sector. The EPSRP program loan focuses on improving fiscal balance, restructuring government operations, and mitigating the social and economic impact of public expenditure adjustment. However, the reforms relating to rationalization of public enterprises are yet to be adequately advanced.

4. Since 1999, NZAID has assisted the Government to address a number of matters: establishing the Overarching Investment Policies applicable to public enterprises, which was approved by the Privy Council, creating a database of information on public enterprises' financial performance; liquidation of nontrading public enterprises, ad hoc reviews and corporatization of selected enterprises; and other financial policy issues as appropriate. Currently 13 public enterprises are subject to the Public Enterprises Act 2002 and around 8 commercial activities are undertaken within government departments. The Public Enterprises Act 2002 was enacted in November 2002 as part of the assistance provided under the EPSRP loan. However, progress with public enterprise reforms has been slow compared with experience in neighboring Pacific developing member countries.

5. In December 1995, the Privy Council⁵ required the Minister for Finance to submit a proposal for a complete review of all government investments with a view to securing adequate

¹ ADB. 2002. *Report and Recommendations of the President to the Board of Directors on a Proposed Loan to the Government of Tonga for the Economic and Public Sector Reform Program*. Manila.

² Formerly New Zealand Overseas Development Assistance (NZODA).

³ ADB. 2002. *Tonga: Country Strategy and Program Update (2003–2005)*. Manila.

⁴ This TA first appeared in *ADB Business Opportunities* (internet version) on 10 February 2003.

⁵ The Privy Council is the highest executive authority in Tonga comprising the Cabinet and chaired by the King of Tonga.

dividend payments. The Government Investment Unit (GIU) was established within the Ministry of Finance (MOF) in July 1999 to monitor public enterprise performance. NZAID has supported this unit with TA, which has resulted in all nontrading public enterprises being closed or prepared for closure, and a number of departmental commercial activities corporatized. The approved Overarching Investment Policies statement includes broad principles on investment and divestment objectives. The statement needs to be supported by detailed criteria and guidelines to provide a consistent framework for operational decision-making and monitoring purposes. With NZAID assistance, policy papers to establish a monitoring framework were prepared, but Government approval has proved difficult to achieve. The GIU has inadequate resources and skills to provide policy support to the minister and Cabinet in the more complex aspects of public enterprise reforms. Assistance is therefore needed to push the reform effort in this area as improved performance by public enterprises will reduce the subsidies that drain the ever decreasing public finances.

6. Although information on the financial position of individual public enterprises is being collected, financial performance of public enterprise has not been analyzed systematically due to the inadequate skills of GIU staff and absence of a financial monitoring framework. A list of public enterprises and departmental commercial activities that will be the subject of the TA is in Appendix 2. Most public enterprises have never paid dividend to the Government. Generally, public enterprises have higher salary structures than the public service and collectively employ around 1,200 people. Although the Government completed privatization of the generation and distribution of electricity in Tongatapu in early 2002 and has allowed some competition in telecommunications (internet access and mobile telephone), no regulatory framework exists to protect the public interest through affordable services and competition.

7. The Public Enterprises Act 2002 recognizes the need for public enterprise reforms but the intent of the act now needs to be translated into a concrete, comprehensive policy framework (including regulations to ensure appropriate and affordable competition) and a detailed time-bound action plan. Constraints to privatization include, among other things, the lack of a clear policy to determine the kind of activities that the Government should be involved in and those that should be transferred to the private sector. Moreover, the Government continues to engage in risky operations that are intended to make up for the perceived deficiencies of the private sector and/or protect the national interest. Further, these decisions have not been made in a transparent manner or within a framework that ensures adequate management of the Government's exposure to commercial risks.

8. The legal status of government commercial activities varies widely. While certain public enterprises are corporatized pursuant to applicable company law or under a special law or statute, others operate as proprietary or revolving funds or are run as part of government departments. While some statutes address competition and regulatory issues to protect the public interest, others do not. Such statutes should be reviewed and remedial measures recommended to ensure a coherent legal framework that facilitates regulation, restructuring, corporate governance, and privatization.

9. The Government is committed to further the process of public enterprise reforms. Building upon the assistance provided by ADB and NZAID under previous TAs, such commitment now needs to be supported through a focused advisory TA to speed the reform process by preparing a coherent policy and regulatory framework and a time-bound action plan.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

10. The purpose of the TA is to assist the Government to implement the public enterprise reform envisaged under the Public Enterprise Act 2002. The TA will assist the Government to (i) formulate a comprehensive policy framework including competition and regulatory arrangements, (ii) review all existing government commercial investments and activities, and (iii) prepare a sequenced set of processes and a timetable for implementing public enterprise reforms. Such reforms will be an integral part of the broader public sector reforms initiated under the EPSRP. The public enterprise reforms will also provide impetus to improve efficiency and financial performance of public enterprises through (i) introducing clear accountability of ministers, boards of directors, and chief executives; and (ii) operational and financial autonomy for management and better business practices.

B. Methodology and Key Activities

11. The TA will include the following key components:

- (i) assistance to the Government in defining the “public interest” criteria to guide decisions on rationalization and privatization, and prepare a detailed action plan to restructure/privatize public enterprises and government commercial activities as appropriate;
- (ii) advice on the formulation of a competition and regulatory policy framework for public enterprise reforms;
- (iii) detailed technical advice on rationalization or privatization of selected public enterprises including corporate and financial restructuring, asset valuation, legal status, taxation treatment, regulatory arrangements, and associated labor issues;
- (iv) advice on strengthening management of individual public enterprises that are to remain under majority government ownership in the short/medium term, as well as specific proposals for improved performance;
- (v) capacity building of the GIU; and
- (vi) advice on consensus building and increasing awareness of stakeholders about issues related to public enterprise reforms.

12. The consultants are expected to provide a comprehensive set of policy recommendations on public enterprise reforms, and help selected enterprises to take steps needed to implement the Government’s policies on rationalization/privatization. The consultants will (i) prepare a brief policy paper setting out “the public interest” criteria to guide government decisions on whether an investment should remain under public ownership; (ii) review and analyze the business and financial position of public enterprises and government commercial activities, and assess the readiness of each public enterprise for restructuring/privatization; (iii) recommend a timetable, and procedures, for implementing the reforms; (iv) prepare a performance monitoring framework for public enterprises; (v) initiate a public awareness strategy; and (vi) prepare a carefully sequenced action plan for rationalization and privatization for approval by Government. The consultants will also provide strategic intervention to help

implement the restructuring program and assess overall funding needs for implementation of the action plan.

C. Cost and Financing

13. The total cost of the TA is estimated at \$640,000, including a foreign exchange cost of \$515,000 and \$125,000 equivalent in local currency cost. ADB will finance \$515,000 covering the entire foreign exchange cost. The TA will be financed on a grant basis by ADB's TA funding program. The Government will contribute \$125,000 equivalent of the local currency cost through provision of office space, adequate counterpart staff including legal staff for the drafting of regulations, local transportation, workshops, seminars and other services. The detailed cost estimates are in Appendix 3.

D. Implementation Arrangements

14. MOF will be the Executing Agency for the TA in close coordination with other departments that support the responsible minister in supervising and monitoring performance of public enterprises. The consultants will work closely with staff of the GIU and the NZAID consultant. MOF will ensure timely access to all relevant information related to public enterprises. A public enterprise reform steering committee will be established and chaired by MOF to provide guidance on TA implementation and act as a forum for information dissemination to affected agencies and stakeholders.

15. A team of international and domestic consultants will be engaged through a firm. The consultants will be selected through the quality and cost-based selection method with simplified technical proposals in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the engagement of domestic consultants. The team will include the following international and domestic consultants for a total of approximately 18 person-months: (i) a public enterprise reform expert; (ii) specialists with experience in corporatization and privatization in telecommunication, electricity, water and shipping; (iii) a financial analyst and adviser; and (iv) a communication adviser with experience in the participatory process and public information campaigns. The communication adviser will be recruited internationally if a qualified domestic consultant is not available. The team will also work closely with the financial analyst provided under an NZAID assistance program to GIU. The consultants will closely collaborate with other externally funded consultants related to public sector reforms to achieve maximum utilization of resources and avoid duplication of efforts. The consultants' outline terms of reference are in Appendix 4.

16. The consultants will prepare an inception report, brief monthly progress reports, a draft final report, and a final report. The draft final report, with detailed proposals for rationalization and privatization, and an action plan will be discussed at a consultative meeting comprising ADB, the MOF steering committee, and the consultants. Detailed reporting requirements are outlined in Appendix 4.

17. The TA will be implemented over a period of 12 months. It is expected to commence in July 2003 and be completed by June 2004. Within 4 weeks after the commencement of the TA, the consultants will submit a brief inception report summarizing the current status of the Government's public enterprise reform program; identifying specific issues; suggesting changes to the methodology and program, if any; and detailing a work program to achieve the agreed outputs. Monthly progress reports will be discussed with the TA implementation steering committee to ensure actions are taken to minimize delays to the achievement of milestones.

The consultants will submit the draft final report for comments by ADB and the implementation steering committee. A tripartite meeting among the Government, ADB and the consultants will discuss the draft final report and any changes to be made. Subsequently, and within 1 month of the tripartite meeting, the consultants will submit the final report incorporating comments received as appropriate. The consultants will submit three hard copies and an electronic version (compact disc) of all reports to ADB and the Government.

IV. THE PRESIDENT'S DECISION

18. The President, acting under authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$515,000 on a grant basis to the Government of Tonga for the Rationalization of Public Enterprises, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Better resource allocation and economic efficiency in the public sector.	Reduction of budget subsidies to public enterprises by at least 50% by fiscal year 2006.	Annual budgets.	
Purpose 1. Improved efficiency of core public enterprises. 2. Transfer noncore public enterprises and commercial activities to the private sector.	Increasing profitability in accordance with government rate of return requirements. Number of public enterprises that are privatized and/or liquidated.	Public enterprises' annual financial statements. Annual budgets.	
Outputs 1. A report setting out "public interest" criteria as guiding principles for government decisions on rationalization of public enterprises and commercial activities. 2. A report on regulatory arrangements for competitive utility services (electricity, telecommunication) and noncompetitive services (interisland transport, water, port).	Acceptance of report by the steering committee. Acceptance of recommendations by the steering committee.	Minutes of meeting. Minutes of meeting.	Continued political will to undertake reforms in this area by Cabinet and Privy Council.

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>3. A detailed plan of rationalization and privatization arising out of reviews of all public enterprises and government commercial activities.</p> <p>4. Policies and procedures on corporate and financial restructuring of public enterprises: asset identification and valuation, debt and capital structure, identification and assessment of social service obligations, identification of outstanding and contingent liabilities including super annuation liabilities.</p> <p>5. Draft paper on the performance-monitoring regime applicable to public enterprises that will remain under majority public ownership.</p> <p>6. A communication program to inform staff and the community about the public enterprise reforms, including social impact mitigation strategy.</p>	<p>Acceptance of recommendations by the steering committee, including the action plan.</p> <p>Acceptance of recommendations by the steering committee.</p> <p>Implementation of the policies and procedures by individual public enterprises within one year of approval.</p> <p>Acceptance of report by the steering committee. Training provided to Government Investment Unit and public enterprises' staff of requirements.</p> <p>Acceptance of communication strategy by the steering committee.</p> <p>Number of consultative meetings with affected staff</p>	<p>Minutes of meeting.</p> <p>Submission of initial financial statements by individual public enterprises in compliance with policies and procedures to the Ministry of Finance (MOF).</p> <p>Minutes of meeting.</p> <p>First monitoring reports prepared by individual public enterprises submitted to ministry of finance.</p> <p>Minutes of meeting.</p> <p>Press reports.</p>	

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
	and the wider community.		
Activities 1. Review current corporate governance in public enterprises in the light of the Public Enterprises Act 2002; draft regulations and instructions on application of the act provisions. 2. Review current regulatory arrangements to encourage competition and to protect the public interest. 3. Review and assess the business and financial position of individual public enterprises to determine a rationalization and privatization plan and actions necessary to get public enterprises ready for privatization as appropriate. 4. Provide advice on corporate and financial restructuring of individual public enterprises. 5. Train Government Investment Unit and public enterprise staff on the	In accordance with timetable. In accordance with timetable. As above. Number of public enterprises advised. Number of staff trained	Consultant's report. Consultant's report. As above. As above.	

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>performance monitoring requirements.</p> <p>6. Provide advice on consensus building and increasing awareness of stakeholders about issues related to public enterprise reforms and the Government's social impact mitigation strategy.</p>			
<p>Inputs Consulting services. Availability of counterpart staff. Asian Development Bank staff resource to manage the technical assistance.</p>			

GOVERNMENT INVESTMENTS AND COMMERCIAL ACTIVITIES

1. The following public enterprises will be subject to all or certain provisions of the Public Enterprise Act 2002:

- (i) International Dateline Hotel, Ltd.;
- (ii) Royal Tongan Airlines, Ltd.;
- (iii) Shipping Corporation of Polynesia, Ltd.;
- (iv) Tonga Corporation;
- (v) Tonga Broadcasting Commission;
- (vi) Tonga Electric Power Board;
- (vii) Ports Authority;
- (viii) Tonga Water Board;
- (ix) Leiola Duty Free, Ltd.;
- (x) Tonga Timber, Ltd.;
- (xi) Tonga Investment, Ltd., comprising

- (a) Frisco Hardware,
- (b) Pili Quarry,
- (c) Home Gas, and
- (d) Primary Produce Export, Ltd.;

- (xii) Tonga Development Bank; and
- (xiii) Tonga Communications Corporation, Ltd.

2. The following departmental commercial activities will be restructured and/or corporatized:

- (i) 'Eua Forest—Ministry of Agriculture, Forestry and Food;
- (ii) Machinery Pool—Ministry of Agriculture, Forestry and Food;
- (iii) Talamahu Market Authority—Ministry of Agriculture, Forestry and Food;
- (iv) Government Printing—Prime Minister's Office;
- (v) Tonga Chronicle—Prime Minister's Office;
- (vi) Small Industries Centre—Ministry of Labor, Commerce and Industry;
- (vii) Survey Operations—Ministry of Works;
- (viii) Quarries Operations—Ministry of Works; and
- (ix) Tonga Post Office (being corporatized)—Ministry of Finance

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. Consultants			
a. Remuneration and Per Diem: International Consultants	390.0	0.0	390.0
b. International and Local Travel	60.0	0.0	60.0
c. Reports and Communications	15.0	0.0	15.0
2. Contingencies	50.0	0.0	50.0
Subtotal (A)	515.0	0.0	515.0
B. Government Financing			
1. Office Accommodation and Transport	0.0	45.0	45.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	50.0	50.0
3. Others: Seminars, Workshops	0.0	30.0	30.0
Subtotal (B)	0.0	125.0	125.0
Total	515.0	125.0	640.0

^a Financed by the Asian Development Bank's technical assistance funding program.
Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. Work Program

1. The technical assistance (TA) will be implemented over a period of about 12 months. The team will work closely with Government Investment Unit (GIU) staff and relevant agencies to (i) prepare a policy framework (public interest criteria) for rationalization and/or privatization of public enterprises; (ii) analyze the business and financial situation of individual public enterprises in order to propose an action plan consistent with the policy framework in point (i); (iii) prepare procedures for the restructuring or privatization of public enterprises; (iv) recommend regulatory rules and arrangements for competitive and privatized businesses (telecommunication, electricity) and nonprivatized utilities (water port and shipping services); (v) recommend a financial monitoring regime for public enterprises that remain under public ownership; and (vi) prepare a communication strategy and measures to mitigate labor, social, and economic impacts on the community. Consulting services will be provided by international and domestic consultants. The team will ensure that labor and environmental impacts are identified, and mitigation measures are incorporated in accordance with the relevant laws prior to privatization. Their designations and tasks are as follows.

B. Consulting Services

1. Public Enterprise Reform Specialist

2. The specialist will have extensive experience in designing and implementing of reforms of public enterprises, preferably with exposure to the Pacific environment; will report to the Minister for Finance and the steering committee; the specialist will

- (i) guide the team of consultants and coordinate all inputs and outputs of the consultants and local counterpart staff, including preparation of reports;
- (ii) will ensure coherence of policy advice and integration of the public enterprise reform component with overall public sector reforms initiated under the Economic and Public Sector Reform Program (EPSRP);
- (iii) assist the Government in formulating the public enterprise reform strategy and prepare a detailed action plan on restructuring and divestment through various modalities, and improving corporate governance in individual public enterprises;
- (iv) establish a transparent process for implementing privatization, and a performance monitoring regime for public enterprises remaining under government ownership, clearly defining authority and accountability of management, regulatory agency and government owner;
- (v) proposed arrangements for developing competition and regulatory strategies for relevant industry sectors;
- (vi) oversee the review, analysis, and assessment of the corporate and financial position of individual public enterprises within the Tongan business environment, the value of each public enterprise, degree of competition, and interest by private investors;

- (vii) discuss the restructuring and privatization modalities and proposals with the steering committee and public enterprise managers, and develop the necessary consensus; oversee the implementation of the public enterprise corporate and financial restructuring plans, including associated financial and labor implications;
- (viii) develop an action plan, including a timetable for the scrutiny of public enterprises and preparatory steps necessary for divestment; and
- (ix) enhance the capacity of policy makers and public enterprise managers by exposing them to international experience, with specific reference to that in neighboring countries, on the approach and modalities for public enterprise restructuring through information seminars and workshops.

2. Specialists

3. Short-term specialist input (such as legal, telecommunication, and electricity) will be required as needs arise during the TA. The team leader will arrange for the availability of specialists as necessary. Specifically, the legal specialist will have extensive experience in corporate law and restructuring of public enterprises and will:

- (i) review the public enterprise legal and regulatory framework and prepare drafting instructions for legislation and regulations necessary for restructuring and privatization of public enterprises, ensuring transparency of the process;
- (ii) advise on changes in legislation and rules and regulations necessary for effective public enterprise reforms;
- (iii) advise on practical arrangements for a regulatory regime appropriate to Tonga's business environment and limited skills and resources; and
- (iv) conduct seminars on legal issues related to restructuring and privatization.

4 Other specialists will be selected as the needs arise

3. Financial Adviser

5. The financial adviser, preferably a certified public accountant or equivalent, will have had extensive experience with financial aspects of public enterprise operations and restructuring. The financial adviser will coordinate the work of GIU staff, the New Zealand Agency for International Development (NZAID) consultant, and public enterprises financial staff. The adviser will

- (i) develop financial restructuring, financial performance monitoring, and privatization guidelines and assist individual public enterprises in implementing them;
- (ii) review the financial information system of public enterprises and recommend measures to bring them into line with generally accepted accounting principles and standards appropriate for their businesses;

- (iii) review financial accounts provided by public enterprises, with assistance from GIU and other team members, to ensure their compliance with generally accepted accounting standards and asset/liability valuation rules approved by the Ministry of Finance (MOF);
- (iv) assess the value and appraise public enterprises in preparation for their restructuring and/or privatization;
- (v) assist relevant public enterprise managers in formulating an action plan with corporate and financial restructuring options to improve public enterprises' sale value or enhance their financial performance if remaining under government ownership; and
- (vi) provide training to counterpart staff in interpreting and analyzing public enterprises' financial accounts and other supporting information.

4. Communication Adviser

6. The consultant will be an integral part of the team and will, in coordination with other team members,

- (i) formulate a consultative process and public information campaign that will engage stakeholders, the private sector, civil society, and the community in the public enterprise reform program as a component of the EPSRP;
- (ii) assist the team leader in arranging effective information sessions for stakeholders (public enterprise employees) to explain the public enterprise reform process and potential impact on this group, including mitigating measures;
- (iii) work with the EPSRP's social and gender impact monitoring unit within the Prime Minister's Office to monitor and assess the reform impact on stakeholders including mitigating responses;
- (iv) provide input to the team leader to enable the preparation of reports required by the steering committee and ADB; and
- (v) arrange workshops and seminars for the groups targeted under points (i) and (ii), with appropriate speakers and venues.

C. Reporting Requirements

7. The following reports will be prepared by the consultants and submitted simultaneously to the Government and ADB:

- (i) an inception report, 4 weeks from the commencement of services, and detailing the current status of the Government's public enterprise reform program and establishing a work program including consultant inputs to achieve agreed outputs;
- (ii) brief monthly reports summarizing the progress of work, major findings, and any problem areas that may hamper the TA;

- (iii) a draft final report incorporating implementation of restructuring/privatizing plan for individual public enterprises, financial monitoring procedures, and recommendations of next steps to complete the restructuring/privatization plan following the format of a report and recommendation to the President with appendixes; and
- (iv) a final report, based on the draft final report incorporating the comments and views received on the draft.