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Corporatization and Privatization of Public Utilities and Other Public Services

Working Paper 7

PINZ
Education... Global Specialists

Prepared for
Government of Palau and
Asian Development Bank

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ACRONYMS

ADB	–	Asian Development Bank
BOO	–	Build Own Operate
BOOT	–	Build Own Operate Transfer
BOT	–	Build Operate Transfer
BPW	–	Bureau of Public Works
CCMAU		Crown Company Monitoring and Advisory Unit
CIP	–	Capital Improvement Project
FEIM	–	Facility for Economic and Infrastructure Management
GDP	–	gross domestic product
GOP	–	Government of Palau
JICA	–	Japan International Cooperation Agency
JV	–	Joint Venture
MOCT	–	Ministry of Commerce and Trade
MOF	–	Ministry of Finance
MORD	–	Ministry of Resources and Development
MTDS	–	Medium-Term Development Strategy
OEK	–	Olbill Era Kelulau
PE	–	Public Enterprise
PIA	–	Palau International Airport
PNCC	–	Palau National Communications Corporation
PPP	–	Public-Private Partnership
PSC	–	Project Steering Committee
SID	–	Support Impact Doable
USO	–	Universal Service Obligation
WB	–	World Bank

CONTENTS

1. Executive Summary

1. This Working Paper considers opportunities for further commercialization, corporatization or privatization of Government operated services in Palau.

2. The Paper has three parts:

   i) A brief description of some of the principles of governance. This is considered important because the consultant believes that in the two government owned corporations that were reviewed there is an important omission within the governance process. In most successful corporatization models a government ministry – typically the Ministry of Finance – provides oversight and commentary to the elected representative on the annual Statement of Corporate Intent, or Business Plan, provided by the Corporation. This element of governance appears to be lacking in Palau. Recommendations for improvement of this element of governance are included in the Working Paper.

   ii) The second, and substantial part of the Working Paper, provides suggested goals (medium term, unquantified achievements) for each institution studied. Each goal is supported by a series of specific proposed strategies, which, in turn, have a number of action points to enable them to be achieved. What is now required is for the goals to be reviewed and accepted or amended. A similar decision is to be made for each of the strategies. Finally, the process can be repeated for the detailed action plans, which will provide a “road map” for implementation management.

   iii) The final part of the Working Paper briefly summarizes background theory relating to corporatization and privatization, and what is necessary for success.

3. The proposed goals and strategies are summarized below:

Overarching Requirement

Goal: Improve the quality of governance of public enterprises.

Strategies:
1 Strengthen oversight of enterprises.
2 Improve the annual planning cycle.
3 Create environment for successful private sector participation.
4 Remove the constraints on improvements in government provided services.

Palau International Airport

Goal: Develop Palau International Airport into fully self funding operation.

Strategies:
1 Improve financial viability.
2 Improve management capacity.
3 Corporatize operations.
4 Introduce benchmarking.

Palau National Communications Corporation

Goal: Ensure Palau retains leadership position in Information and Communications Technology in the Pacific; increase the attractiveness of PNCC to private sector investors.

Strategies:
1 Introduce competitive neutrality into the sector.
2 Ensure PNCC remains sustainable and fully self funding.
3 Increase attractiveness of PNCC to private sector investors.
4 Improve governance.

Palau Public Utilities Corporation

Goal: Minimize the need for government support for the sector, thus making it more attractive to private sector investors in the future.

Strategies:
1 Progressive tariff increases to increase level of cost recovery.
2 Improve attractiveness of sector to investors.
3 Introduce cost reduction campaign.
4 Improve governance.
5 Centralize sector structure and integrate planning.
6 Consider inviting private sector to invest in sector.

Bureau of Public Works

Goals: To increase productivity and efficiency.

To identify appropriate funding and service delivery mechanisms for future services.

Strategies:
1 Improve governance.
2 Regulate standards.
3 Improve asset management.
4 Review and prioritize capital investment program.
5 Contract to private sector where this provides greater value.
6 Assess interest of private sector in providing solid waste and water and sewerage services.

Health and Education

Goal: Reduce costs through private sector participation.

Strategies:
1 Open ups selected services to private sector.
2 Achieve full cost recovery from private sector.

Malakal Port

Goal: Short term security of supply.

Strategies:
1. Full Cost recovery.
2. Introduce safeguards relating to monopoly position.
3. "Gain time" while future port requirements are evaluated.

4. The proposed goals and strategies have been discussed in the Project Steering Committee (PSC), and a ranking provided. In many instances the proposed goal and strategy has been supported, but there is some level of concern about the capacity to successfully implement the proposals. Some consulting assistance has already been recommended in a small number of selected areas, but in other cases the consultant believes that by following the proposed action plan it will be possible for local officials, supported by some local expertise, to successfully manage the proposed implementation.

5. The consultant has suggested that the work can be completed within a three year time frame.

6. What is now required are decisions on which goals, strategies and action plans are supported, and agreement on specific responsibilities for implementation, and an associated time frame.

2. Introduction

7. This Working Paper addresses the requirement for "a Paper on privatization of public utilities and other public services". Privatization in this context is taken to include corporatization, which can be considered one modality in a much wider spectrum of privatization options.

8. This Working Paper should be read in conjunction with Working Papers 1 – 6, which have provided more detailed diagnoses of the performance of Palau National Communications Corporation (PNCC); Palau International Airport (PIA); Bureau of Public Works (BPW); Palau Public Utilities Corporation (PPUC); opportunities for private sector involvement in the health and education sectors; and priorities for the Malakal port concession.

9. This Working Paper focuses on suggested goals, strategies and action plans that will provide improved performance in each of these sectors over the next three years. With the exception of Malakal port, these goals and strategies were presented to the PSC on 18 June 2008, and were ranked by those present, using the Support, Impact, Do-able rating that is being applied to all project proposals. These rankings are included in this Working Paper.

10. In addition to the introduction, this Paper has three parts:

    i) A very short description of governance principles, since these underpin successful performance of both profit driven and other institutions;

    ii) Suggested goals, strategies and action plans for each of the institutions included in the scope of work of the Privatization Specialist. These have been presented in such a way that acceptance of the recommended goal leads on to consideration of the strategies to achieve it, while acceptance of the strategies leads to consideration of the proposed action plans associated with each strategy. Similarly, changes in goals or strategies will lead to changes in the supporting strategies or action plans. The completed proposals will provide a "road map" for implementation and a useful tool for project management;

    iii) The third component of the Working Paper is a short description of some of the theory behind corporatization and privatization, and features that are necessary for success. Privatization is a subject of substantial books, which treat the subject in much greater detail than can be expected in a Working Paper, which also tries to apply lessons to specific opportunities within Palau. Inevitably, therefore, the scope of this Working Paper is focussed at an overview level only.

11. As discussed in the detailed Working Papers, there are a number of fundamental considerations that underpin successful corporatization and privatization, and the choice of the most appropriate strategies to be followed in reform. Each of the following requirements has been considered in the Working Papers and proposed goals and strategies. First is the question of the enabling environment – is it conducive to private sector participation and development and is the sector attractive commercially? Second is the question of having a regulatory framework that both ensures "a level playing field" and provides controls to prevent possible abuse of monopoly power. Third is the issue of cost recovery and policies for requiring universal service obligations

when some services are unprofitable. Policies are therefore required on how to target subsidies, ideally to make them “pro poor”, whilst leaving those with a greater ability to pay meet the full costs of services they use.

3. Governance

12. The term “governance” is used frequently in this Working Paper. In very general terms, the following concepts underpin governance responsibilities with respect to corporatization and public enterprise reform:

    i) Each institution provides a Business Plan, or Annual Plan (in a corporatized context also referred to as “Statements of Corporate Intent”) covering a rolling three year period, with the first year in some detail, including measurable performance targets, and the following two years in more general terms;

    ii) Corporatized institutions are expected to emulate the private sector and to operate as successful (profitable) businesses. They are not expected to pursue social objectives unless they receive targeted financial support from government to do so;

    iii) “Management” is accountable for operations and efficiency;

    iv) Boards of Directors, where they exist, or, in their absence, senior Ministry teams, oversee and approve annual plans and review actual performance against plans. Boards of Directors do not get involved in operational (day to day) decision making. Their focus is at a higher level than management;

    v) Final decision making on acceptability of plans rests with Ministers and, through them, with Olbiil Era Kelulau (OEK);

    vi) To enable OEK to do this for major corporatized or revenue generating institutions, they receive an independent assessment of the quality and content of the Plans submitted for approval. This assessment would normally be provided by officials within the Ministry of Finance, who act as Advisors, but with no authority to require changes. Any decisions imposing changes rest with elected representatives. The Ministry assessment would include consideration of alignment with national economic and fiscal strategies; the quality of assumptions underlying financial and other projections; investment proposals and source of funds; dividend policies, in the case of fully corporatized enterprises; any changes in the scope of business (for instance business diversification or withdrawal from some service currently provided).

    vii) Ministries are responsible for policy. Under Public Sector Reform strategies adopted in many countries Ministries are no longer responsible for service delivery, since this removes the objectivity of a group that focuses entirely on policy and sector performance. Policy and service delivery are regarded as quite separate functions.

    viii) Broader public sector reform strategies have focused on identifying added value from individual operations, and eliminating those tasks that are essentially administrative, and do not add value.

13. The following sections set out suggested goals, strategies and action plans for each of the sectors reviewed by the Privatization Specialist. Rankings, out of 10, and with a 50 percent weighting to Impact are based on the assessments made by members of the

PSC, using the “Support, Impact Do-able ranking described in greater detail in the Medium-Term Development Paper.

14. As discussed in paragraph 6 above, and in the description of Governance principles, it is important to establish an enabling environment in which corporatization or privatization can bring maximum benefits. The first goal described below is an overarching goal intended to contribute to improved governance and the creation of an environment in which each institution can improve its productivity. Subsequent goals relate to individual sectors that have been included in the review. Each analysis is preceded by a short diagnosis of the current situation leading to the recommended goal, strategies and action plans.

4. Proposed Goals and Strategies

4.1 Overarching Requirements

15. This Technical Assistance involved a diagnosis of the performance and efficiency of a number of Government of Palau (GOP) institutions, some of which have already been corporatized while others continue to operate as Government Departments.

16. A number of common themes have emerged that apply to all these activities. These have therefore been broadly grouped as overarching themes. Proposed strategies to address these issues impact all institutions, and the enabling environment for possible future private sector participation in service delivery in these areas.

17. The common themes underpin the question of whether GOP, and the citizens of Palau, are receiving the best possible value from the services under review. Particular concerns are:

    i) The adequacy of existing governance mechanisms;

    ii) The impact of Universal Service Obligations on costs for some enterprises, in particular PNCC and PPUC, and the absence of targeting of subsidies. This is addressed in proposed goals and strategies for these particular enterprises;

    iii) The absence of adequate regulatory frameworks to ensure there is no opportunity for abuse of monopoly power if the private sector becomes a more dominant service provider;

    iv) What can be done to make individual sectors attractive to private sector investors, in order to reduce demands for financial support from GOP for future capital investments or operating deficits.

18. The best practice corporatization model has not been replicated completely**. What is missing in Palau is the feedback link between the Government, as shareholder, and the Board of Directors.** In other successful models a government Ministry – typically the Ministry of Finance – reviews the Business Plans of the corporatized institutions, and periodically – at least every six months – compares actual performance against plan. The Ministry will consider alignment of Business Plans with national objectives; proposed investments and the associated rate of return, and any proposed changes in the scope of business. The Ministry is not empowered to change the Business Plan. It can refer queries back to the Board of Directors, and it is responsible for providing a commentary on the Business Plan and actual performance to elected representatives.

19. The Ministry involvement introduces a strong element of accountability of the Board of Directors to the Government. It provides the opportunity for informed comment, and independent, expert scrutiny.

20. The thrust of the proposed overarching goal is to improve the quality of governance by addressing this missing link, thus improving the quality of governance. Four strategies are proposed, with supporting detailed action plans. Included within these action plans are specific steps to improve the quality of Business Plans, and proposed wider exposure of officials to how overseas governments exercise oversight of government owned corporations.

21. Implementation costs will be minimal, since the strategies essentially involve rechannelling existing staff effort into higher added value activities. In the initial stages of implementation

there will be some training costs involved, and possibly a study tour to review best practice overseas.

22. The expected outcome from the overarching goal is a significant improvement in the quality of Business Plans and resource allocation across all government activities, and increased attractiveness of the sectors to private sector investors.

23. The ranking for the proposed strategies suggest a high degree of support for the proposals, but concern about how “do-able” some of the proposals are, in particular related to creating an environment in which the private sector is encouraged to become involved in activities currently performed by government institutions.

Table 1 Overarching Goal - Improve the Quality of Governance of Public Enterprises

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost	Timing
1	Strengthen oversight of enterprises	9.4	9.6	8.2	9.2	MOF	$32,000	2008
2	Improve the annual planning cycle	9.2	9.2	8.4	9.0	MOF	Existing	2008 – 09
3	Create environment for successful private sector participation	9.0	9.2	6.6	8.4	MOF	$109,000	2008 – 09
4	Remove the constraints on improvements in government provided services	8.25	9.0	6.0	8.1	MOF	Existing	2008 – 09

Table 2 Action Plan to Achieve Improved Governance of Public Enterprises

Strategy	Action No.	Action
1 Strengthen oversight of enterprises.	1.1	Define improved processes for Ministry of Finance to critique and prepare commentary on public enterprises Business Plans, and opportunities for full cost recovery.
	1.2	Review and refine individual Ministries responsibilities for policy, service delivery and performance monitoring. Define delegated authority limits within Ministries and Public Enterprises (PEs).
	1.3	If necessary, approve enabling legislation mandating revised authority.
	1.4	Provide template for content of Business Plans to be provided by Public Enterprises. The Annual Plans (Statements of Corporate Intent) should cover the following 12 months in detail, and the two subsequent years in more general terms. The Business Plans should specify all major capital expenditure proposals, Return on Asset targets, and identify any financing gaps.
	1.5	If necessary, provide training to Ministry of Finance staff on “what a good Business Plan looks like”. Seek funding for, and undertake, a review of successful governance mechanisms in other countries such as Australia or New Zealand.
	1.6	Provide training to Boards of Directors and senior managers on content and substance of Business

		Plans.
	1.7	Conduct workshop with boards/management of public enterprises to identify restraining forces that are impeding performance, and consider possible remedial actions.
	1.8	Set up Public Enterprise performance monitoring systems with key performance indicators for major outputs, and assign responsibility for maintenance.
	1.9	Determine and publicize policy position on private sector involvement and public private partnerships.
	1.10	Develop and implement policy on Universal Service Obligations and associated targeting of subsidies.
2 Improve Annual Planning Cycle.	2.1	Advise PEs of national economic goals and any expenditure constraints to be considered when developing annual Business Plans.
	2.2	Provide feedback to Boards and senior management of level of satisfaction with Corporation performance against plan.
	2.3	Ensure that Ministry of Finance and functional Ministries commentaries of performance against key performance indicators are provided be each institution.
	2.4	Produce Annual Performance Report setting out key results for each Corporation, for dissemination to public.
3 Create environment for successful private sector participation.	3.1	Introduce regulatory frameworks, after researching availability and suitability of other models in the Pacific and elsewhere. In doing so, ensure that risks of profitable markets only being serviced by the private sector, leaving high cost segments for GOP utilities.
	3.2	Develop costings and define expertise for Regulatory Authority, to be established.
	3.3	Increase transparency and eliminate hidden subsidies, such as labor costs not being charged against repair jobs.
	3.4	Address wider business environment issues such as labor and taxation, identified elsewhere in fiscal paper.
	3.5	Develop and publicize infrastructure maintenance plans for each sector.
4 Remove constraints on improvements in Government provided	4.1	Identify those areas where staff productivity is low because of lack of access to raw materials, and the costs and increased output that can occur if additional funding is made available. (This action applies in particular to BPW).

services.	4.2	Obtain position papers from all PEs on deferred maintenance, its implications and the associated costs.
	4.3	Balance employee numbers with financial allocations for materials, in order to remove excessive idle time caused by lack of resources.
	4.4	Review possibilities of reactivating the "Reduction in Force" policies, in order to reduce personnel costs where Boards of Directors consider these appropriate.

24. Appendix 1 provides details of the cost estimates associated with the above action plans, in those cases where expenditure is not covered by existing wage and salary costs.

4.2 Palau National Communications Corporation

25. Working Paper 1 contains a more detailed diagnosis of the performance of Palau National Communications Corporation (PNCC).

26. PNCC has been successfully corporatized, and operates in a competitive market. However, PNCC is considered to be at a competitive disadvantage compared with existing or potential private sector investors in the telecommunications sector in Palau. PNCC is required to meet Universal Service Obligations, estimated by the organization to cost USD2.85 million (m) per annum; its financial structure is based on debt; and it must service a loan which has USD51.3m outstanding, and requires a further USD2.3m per annum in debt servicing costs.

27. Whilst private sector competitors who have entered the Palauan market have provided their own infrastructure, they have also focussed on the high density segment of the market, leaving PNCC to service low density locations which effectively require cross subsidization through the tariff structure.

28. One result is that PNCC has a very low return on assets, at only 3 percent, making future investment in the Corporation by the private sector a somewhat unlikely proposition.

29. The Working Paper has suggested three medium term broad goals for the sector:

    i) Introducing competitive neutrality, with no single service provider being advantaged or disadvantaged;

    ii) Ensuring that PNCC remains sustainable and fully self financing; and

    iii) Making PNCC attractive to private sector investors, in order to attract future capital investments and upgrades in technology.

30. In effect, the broad intention of the proposed goal and strategies is to create the “level playing field” necessary for both public and private enterprises to compete successfully. The following tables indicate proposed goals, strategies and actions, and the level of support these proposals have received by those attending the PSC where this was discussed.

31. It is noted that, in common with the responses on other institutions, there is some lack of confidence in the ability to follow through on the strategies. However, the detailed action plans are intended to make this process as simple as possible. Consulting assistance with the development of a regulatory framework and subsidy policy is recommended.

32. The expected outcome from these actions will be greater equality between PNCC and private sector operators; increased contributions from private sector competitors to the sunk costs of existing infrastructure necessary to provide equal quality of service to all Palauans, and increasing attractiveness of PNCC as an investment vehicle for private sector investors in telecommunications technologies.

Table 3 Palau National Communications Corporation

Proposed Goal: Ensure Palau retains the leadership position in Information and Communications technology, thus increasing the attractiveness of PNCC to private sector investors

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost	Timing
1	Introduce competitive neutrality into the sector.	8.4	9.0	7.6	8.5	MOF	$64,000	2008
2	Ensure PNCC remains sustainable and fully self funding.	9.6	9.2	6.0	8.5	MOF	Existing	Ongoing
3	Increase attractiveness of PNCC to private sector investors.	9.0	9.0	6.6	8.4	MOF PNCC	Existing	Ongoing
4	Improve governance.	10	10	9.0	9.75	MOF	$29,000	Ongoing

Table 4 Palau National Communications Corporation – Proposed Action Plan

Strategy	Action No.	Action
1 Introduce competitive neutrality into the sector.	1.1	Complete detailed analysis of financial implications of Universal Service Obligations and support mechanisms available to meet these costs, including levies on all service providers.
	1.2	Develop a regulatory framework to be applied to both the private sector and PNCC. This must address funding for national infrastructure, connectivity, tariff setting and notification and market dominance .
	1.3	Broaden financing base for USO support.
2 Ensure PNCC remains sustainable and fully self funding.	2.1	Consider financial debt restructuring debt for PNCC.
3 Increase attractiveness of PNCC attractive to private sector.	3.1	Identify key strategic partners with compatible technologies and interests in gaining market share in the Pacific.

Strategy	Action No.	Action
4 Improve Governance.	4.1	Introduce improved oversight of annual business plans by the Ministry of Finance, (in line with governance recommendations made earlier).
	4.2	Introduce benchmarking to compare efficiency with other Pacific nations Information and Communications Technology providers.

33. Consulting assistance is recommended to draft a proposed regulatory framework, and to assess approaches to USO costs. The basis for determining these costs is given in Appendix 2.

4.3 Palau International Airport

34. More detailed information on the diagnosis for Palau International Airport (PIA) has been provided in Working Paper 2.

35. PIA is currently operated as a Government Department, rather than a Corporation. As indicated in the Working Paper:

i) Many international airports, including those with economies substantially dependent on tourism, are run as profitable institutions;

ii) For PIA, there is no single source of information on costs and revenue, making it impossible to assess the cost efficiency of the operation;

iii) Tariffs were last adjusted, in 2002, suggesting there is not full cost recovery, including depreciation, on many capital items, including recently acquired infrastructure such as fire and rescue equipment, costing USD3m;

iv) Airport users can be considered to have a high ability to pay, so that when developing tariffs, social or pro poor considerations are of low importance;

v) PIA forward planning is limited to a 12 month time horizon only;

vi) There is no marketing of the facility;

vii) There is a large difference between the expenditure projected by the airport management as necessary to run the airport, and funding approved by GOP. This implies that some operating activities will be deferred, or that management does not fully appreciate what is, and is not, essential for operation;

viii) Operating the airport as a government department with no financial incentives means that the private sector will not be interested in contributing to future capital expenditure;

ix) There is no recent assessment of opportunities to increase revenue from ancillary services, such as fuel supply and premises rental. In many international airports these are significant sources of revenue;

x) Infrastructure capacity is not balanced, resulting in surplus equipment or bottlenecks in processing; and

xi) The present organization structure means that there is no focus on operating the airport as a business, or producing integrated development plans.

36. In the absence of financial data it is not possible to project the financial benefits to GOP from improved operations. If some proportion of future investment is to be provided by the private sector, thus freeing up Government funds for other less commercial activities such as health and education, then this must be remedied

37. The proposed goal envisages improving planning and cost recovery for PIA, and moving to fully corporatized operation, with performance benchmarking against other airports to ensure that operations are efficient. The expected outcomes will be a much clearer understanding of the financial performance of PIA; increased revenue for GOP, thus reducing demands of future grant assistance for replacement of equipment such as safety and rescue appliances, and medium-term positioning of the airport as an attractive proposition for private sector investors.

38. The scoring has indicated wide support for increasing revenue and management capacity, but more caution on moving forward with corporatization.

Table 5 Palau International Airport

Proposed Goal: Develop Palau International Airport into fully self funding operation

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost USD	Timing
1	Improve financial viability.	10	9.2	7.0	8.85	MOF MOCT	Existing	2008
2	Improve management capacity.	9.8	10	7.0	9.2	MOF MOCT	$44,000	2009
3	Corporatize operations.	6.4	7.8	5.2	6.8	MOF MOCT	$12,500	2009
4	Introduce benchmarking.	9.0	8.0	8.4	8.35	MOF MOCT	$29,000	2009

Table 6 Palau International Airport Proposed Action Plan

Strategy	Action No.	Action
1 Improve financial viability.	1.1	Immediate review of tariff levels, and extent of cost recovery. (If appropriate, this should be conducted concurrently with any measures to increase revenue to fund costs associated with tourism development and maintenance of infrastructure to support tourist activities).
2 Improve management capacity.	2.1	Establish integrated financial reports and management information system for airport operations, to provide consolidated picture of efficiency.
	2.2	Identify key performance indicators and monitoring processes for airport.
	2.3	Ensure an adequate training program for senior management.
	2.4	Require production of comprehensive Business Plan, covering following 12 months in detail, and next

		two years in indicative terms.
3 Corporatize operations.	3.1	Make decision to proceed with corporatization in principle, subject to in depth feasibility study.
	3.2	Set up “Airport Corporatization Establishment Committee” to complete feasibility study that considers: 1. Financial allocations and break even, after considering all associated operating costs; the requirement to cost recover charges, and indicative scope for cost reductions; 2. Proposed financial structure, including capital structure for new operation, and any loan servicing obligations; 3. Potential return on assets; 4. Revised tariff, to fully recover all costs including depreciation and maintenance for commercial services; 5. Impact on airline contracts; 6. Implication on service contracts e.g. for security services; 7. Requirement for, and cost of, non commercial obligations e.g. to US military; 8. Responsibilities that transfer from Ministry to new Company, together with assessment of impact on staff workloads; 9. Proposed organization structure and staffing levels; 10. Recruitment and selection processes for staff, (who should not necessarily transfer to the new Corporation automatically, as appointments should reflect ability); 11. Opportunities for short term cost reductions; 12. Adequacy of Management Information System; 13. Human Resources policies, covering both airport and Ministry staff affected by any staff adjustments at the airport; 14. New requirements e.g. marketing; 15. Opportunities for additional income e.g. rental from land and premises.
	3.3	Decision on whether to proceed with final implementation.
	3.4	Selection and appointment of Board of Directors.
	3.5	Draft and approve any necessary legislation.
	3.6	Formal implementation of Corporatization.

4 Efficiency Measures	4.1	Consider opportunities to introduce regional "airport benchmarking" to provide monitoring mechanism to assess efficiency. This will need to cover both tariffs, operating costs and government subsidies.

39. All work can be undertaken using existing staff, allocated to this development as a special project.

40. The Working Paper itself contains some additional comparisons of ownership models for airports, and policy considerations such as the need for a regulatory framework.

41. A breakdown of the cost estimates is provided at Appendix 3.

4.4 Bureau of Public Works

42. Working Paper 3 provides greater information on the diagnosis of the Bureau of Public Works (BPW).

43. The Bureau acts as a Department of Government, but with a wide range of services, including:

    i) Facilities and Maintenance, providing carpentry, electrical equipment and air conditioning services, and plumbing
    ii) Road and equipment maintenance
    iii) Water and Sewerage supplies and maintenance
    iv) Solid Waste management
    v) Other miscellaneous services including design and engineering and unexploded ordinance controls.

44. As identified in the Working Paper, BPW faces a number of challenges. In particular, there is:

    i) an absence of financial data, making it difficult to quantify full cost recovery tariffs (if this is deemed to be an appropriate objective) or to determine realistic subsidy levels;
    ii) a shortage of resources, in terms of plant and equipment, or fuel for moving between locations, resulting in low employee productivity and high idle time;
    iii) scope for improvement in the quality of strategic plans, and in subsequent performance monitoring;
    iv) the need for significant future capital investments in solid waste management;
    v) inadequate funding for road maintenance, resulting in increasingly rapid deterioration of roads that are neglected and avoidably high whole of life costs;
    vi) a requirement for a review of proposed capital investments, to ensure that all items are costed, and a time bound procurement plan is considered. This is considered essential for forward planning at a Ministry level;
    vii) a need for an assessment of the economic and financial returns that proposed capital investments will provide;
    viii) a need to re-prioritize capital investments based on (i) urgency; (ii) availability of funds; and (iii) economic and financial returns.

45. The proposed goals and strategies for BPW are based on the principles of:

    i) Improving the quality of planning within BPW, thus enabling it to make a better case for financial resources;
    ii) Increasing financial transparency, by developing a financial structure that links all longer term costs within each major activity, to provide a better indication of what levels of cost recovery are necessary, and therefore tariff rates or subsidies
    iii) Assembling a data base of information, through the business planning process, that can be used if required to seek private sector operators to take up concessions for those activities such as solid waste management, where major capital investments are required

which may be beyond the capacity of GOP to finance

iv) Introducing greater private sector contracting where this is more cost effective, and BPW cannot demonstrate that it can deliver the required services at equal levels of cost and efficiency.

46. The benefits from the proposed goals and action plans are that GOP will be better placed to:

i) manage funding allocations to BPW, with increased emphasis on whole of life asset management and employee productivity;

ii) seek private sector involvement in activities currently performed by BPW where this presents cost advantages;

iii) obtain private sector investment and expertise in operations requiring major capital injections;

iv) demonstrate to potential private sector investors that GOP has a sound understanding of existing performance within major sectors of BPW operations, and the associated operational funding requirements and tariff implications.

47. The longer term outcomes from the proposed goals will be a strengthening of management capacity within BPW; a workforce that is more motivated and productive, and better resourced to do what they are employed to do; the potential to receive price competitive proposals from the private sector to undertake future services; and the ability to compare such proposals with the true cost of carrying out this work with government resources..

48. It is noted that whilst the scoring for individual strategies is generally high, there appears to be a degree of pessimism on the national capacity to translate these strategies into tangible improvements.

Table 7 Bureau of Public Works

Proposed Goals: **(1) To significantly increase productivity and efficiency, and**

(2) identify appropriate funding and service delivery mechanisms for future services

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost USD	Timing
1	Improve Governance.	9.5	9.0	5.5	8.25	MOF MORD	$41,500	2008
2	Regulate standards.	9.0	9.0	6.5	8.38	MOF MORD	$41,500	2009
3	Improve asset management.	9.5	8.75	6.0	8.25	MORD BPW	Requires Costing	2008 - 09
4	Review and prioritize capital investment program.	9.0	9.25	7.0	8.6	BPW MORD	JICA	2008
5	Contract to private sector where this provides greater value.	7.5	8.25	6.75	7.7	MORD BPW	$41,500	2009
6	Assess interest of private sector in providing solid waste and water and sewerage services.	7.75	8.75	6.0	7.8	MOF MORD	$82,000	2009

Table 8 Bureau of Public Works – Proposed Action Plan

Strategy	Action No.	Action
1 Improve Governance.	1.1	Introduce improved Business Plans for all sector activities, that reflect detailed intentions for following 12 months, and more general intentions for following two years.
	1.2	These plans to be subject to Ministry of Finance scrutiny on same basis as PNCC and PPUC plans.
	1.3	Provide training to senior management in the preparation of Business Plans, and in performance

		management.
	1.4	Develop a simple performance management system to provide improved information on outputs against plan for each work unit within BPW. The system should include target billable time for each operation.
	1.5	Establish levels of idle time attributable to lack of raw materials or fuel. (This can be done through a simple survey, or estimates from staff).
	1.6	Identify "value added" from all administrative support services, and whether discontinuance of these activities represents an opportunity for cost reduction.
	1.7	Include labor costs in job costs for maintenance.
2 Regulate Standards.	2.1	Specify standards to be applied across all sectors on BPW services, so that private sector can consider whether to the market is attractive. These standards should include reference to such matters as infrastructure maintenance; quality of product (especially for water supply and for land fill, and for septic tank and composting toilet design, which is currently not adequately specified).
3 Improve asset maintenance.	3.1	Introduce basic Geographical Information System linked Road Asset Management System to track quality of roads and projected maintenance needs.
	3.2	Work with State governments to combine responsibility of both National and State governments for road maintenance, since the country is too small to have separated functions.
	3.3	Update asset ownership data base with projected costs of deferred maintenance for all infrastructure assets, indicating the nature of the deficiency (e.g. water losses) and associated cost projections.
	3.4	Produce indicative estimates of the cost of deferred maintenance, based on rehabilitation costs say five years later, if work is not undertaken on schedule.
4 Capital Investment Program.	4.1	Revise and update proposed Capital Expenditure for each working unit, indicating proposed time scale for investments and any source of funds.
	4.2	Provide forecasts of future projected capacity requirements, and how soon existing capacity will be need to be increased.
	4.3	Determine break even point for water supply, sanitation and solid waste management, costed on the basis of full cost recovery and no GOP financial support for these activities.
	4.4	Identify the funding gap that must be addressed to cover the difference between full operating costs

		and tariff receipts.
5 Contract to private sector where this provides greater value.	5.1	Outsource Design and Engineering and Unexploded Ordinances to the private sector, with preference being given for the initial lease (say 2 years) to existing staff. If GOP facilities are to be used by the private sector, then these should be charged at cost.
	5.2	Require Facilities and Maintenance Division to include full recovery of labor costs in all its job quotations or work on carpentry, electrical maintenance, air conditioning repairs and plumbing services.
	5.3	For random sample of jobs to be undertaken by Facilities and Maintenance Division, obtain competitive quotations from the private sector, as first step in assessing costs and benefits of contracting to private sector.
	5.4	After three months, reassess the financial viability of Facilities and Maintenance Division, to assess its competitiveness with the private sector, after adjusting its costs to include idle time and use of plant and equipment.
	5.5	Apply a similar approach to Rural Sanitation Services, whilst allowing the service to undertake other revenue generating activities (that may be outside normal GOP services) in order to offset idle time.
	5.6	If the above feasibility studies indicate that the private sector can be more competitive, then move to full outsourcing of maintenance in the above areas.
6 Assess interest of private sector in providing solid waste management services.	6.1	Define future tariff review mechanisms for solid waste management and for water supply and sanitation, and any subsidy or cross subsidy policies.
	6.2	Identify any safeguards considered necessary for solid waste management and water and sanitation services e.g. for protection of environment and maintenance of infrastructure.
	6.3	Define regulatory requirements and expected performance standards from future operators, and any penalties for non performance.
	6.4	Develop operating models of new solid waste management facility, and water supply and sewerage services, allowing for full recovery of all costs, including maintenance and depreciation, and identify any “funding gap” caused by a shortfall between projected tariff revenue and costs.
	6.5	Advertise internationally for Expressions of Interest from private sector operators. If sufficient interest exists to create contestability of supply, then issue tender documents to compare cost proposals with government operated supplies.
	6.6	Develop policy on extent of benefits of operating water supply and sewerage services, and solid waste management, as Corporations, or offering concessions to the private sector to operate these services.

		This decision should be made in the light of the projected capital expenditure required in the short term for solid waste management.
	6.7	If the policy provides for private sector participation in water and sewerage services, and sold waste management, develop appropriate regulatory frameworks, including environmental considerations and safeguards, and severe penalties for non compliance (since in some areas this could be detrimental to the tourist industry).

49. Consulting assistance is proposed with the development of the first improved business plan for BPW. The basis for costing this assistance is given in Appendix 4.

4.5 Palau Public Utilities Corporation

50. Working Paper 4 provides more information on the diagnosis of performance of Palau Public Utilities Corporation (PPUC).

51. Two independent studies have recommended significant (over 50 percent) tariff increases, and a need for more frequent tariff revisions in order to keep pace with rapidly increasing international oil prices.

52. Significant investments will also be required to replace generators which are at the end of their economic life.

53. The Working Paper notes that:

   i) The Corporation has reported increasing operating losses since 2001, although these were partly offset in 2001 and 2002 by non operating income (the source of which is not clear);

   ii) The Board of Directors is stated to have pursued strategies to breakeven, although this has plainly not been achieved;

   iii) Based on information in other consulting reports, no action has been taken to adjust tariffs to reflect increases in costs apart from fuel costs;

   iv) The tariff adjustment clause creates "lags" in cost recovery, because it can only be activated quarterly, leaving PPUC to cover increased fuel costs in the intervening period;

   v) There is limited ability to control costs, since some 77 percent of costs relate to fuel purchases;

   vi) Deferred maintenance on diesel engines has led to poor fuel economy and costly repairs, some of which may have been avoided;

   vii) As with PNCC, the Corporation must use internal cross subsidies to cover low density areas where costs are significantly higher than tariffs, because of universal service obligations;

   viii) There are synergies between work on alternative energy being undertaken within the Energy Office of the BPW and PPUC planning, but these are only likely to be achieved if the two groups are merged;

   ix) There is scope for encouraging Independent Power Producers (IPPs), who have expressed interest in the past, but not produced substantive proposals because the tariff levels offered have been uneconomic. However, these tariff levels have also been uneconomic for PPUC, as demonstrated by the financial reports;

   x) If proposed turnaround plans are insufficient to achieve the desired results, it may be necessary to consider further privatization, through contract management or a long term concession.

54. The Working Paper suggests a number of alternative strategies to improve the performance of PPUC. If GOP is not prepared to face substantial and ongoing subsidies for the electricity sector then significant improvements are required. GOP will be better placed to demonstrate to donors or private sector investors that investment in replacement generating capacity can be justified based on improvements in governance and cost recovery policies aimed at reducing losses suffered by the Corporation. This does not preclude pro poor subsidies.

55. The outcome from the proposed intervention will be a Corporation that has:

i) more clearly defined business objectives and cost recovery strategies that do not confuse social obligations with the need to run a sustainable business

ii) targeted subsidy policies that provide support for those with limited ability to pay, whilst introducing equitable tariffs for those with an ability to pay;

iii) demonstrated to potential donors or investors that electricity generation, transmission and distribution is being undertaken on a sustainable basis;

iv) a fallback position that can involve a higher degree of privatization if PPUC is unable to demonstrate that it can operate the sector efficiently at sustainable tariff levels

56. The following recommended goal, strategies and action plans are focused on creating a financially sustainable institution.

Table 9 Palau Public Utilities Corporation

Goal: Minimise the need for government support for the sector, thus making it more attractive to private sector investors in the future.

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost	Timing
1	Progressive tariff increases to improve level of cost recovery	7.6	9.6	6.4	8.3			
2	Improve attractiveness of sector to investors	9.2	9.4	6.8	8.7			
3	Introduce cost reduction campaign	9.6	9.2	7.8	8.95			
4	Improve governance	9.6	8.6	8.2	8.75			
5	Centralize sector structure and integrate planning	8.2	8.6	6.0	7.85			
6	Consider inviting private sector to invest in sector	8.0	8.4	7.2	8.0			

Table 10 Palau Public Utility Corporation Action Plan

Strategy	Action No.	Action
1 Progressive tariff increases, to increase level of cost recovery.	1.1	Identify extent of cross subsidies for low population density areas implicit in existing tariffs.
	1.2	Review policy positions on Universal Service Obligations and cost recovery, including proposed subsidies for following three years, possibly through targeted subsidies, rather than block grants. This analysis should consider differential costs of servicing less profitable locations, and ability to pay amongst low income families.
	1.3	Commence and maintain a public information campaign on cost structure and need for tariff increases, and associated performance improvement strategies.
	1.4	Introduce further short term tariff increases, with monthly reviews based on fuel costs and annual reviews to ensure recovery of other costs.
	1.5	Ensure rigorous disconnection policies for non payment of electricity bills. Quarterly list of defaulters to be provided to Ministry and the public.
2 Improve sector attractiveness to investors.	2.1	Develop regulatory regime and pass necessary legislation, including policies on tariffs and cost recovery that will apply to all future service providers. The regulatory regime will include reference to equipment maintenance and USO obligations.
	2.2	Ensure that all electricity use is paid for – for instance including full cost recovery for street lighting.
3 Introduce cost reduction campaign.	3.1	Request Directors and senior management of PPUC to provide a costed and itemized list of opportunities for cost reduction. (This may be of only limited impact, since little can be done about fuel costs, and the risks of deferring maintenance. It will, however, focus attention on the need for a cost containment action plan).
	3.2	Introduce demand management, to reduce electricity consumption, and therefore the need for additional generating capacity.
4 Improve Governance.	4.1	Introduce improved oversight of annual business plans by the Ministry of Finance, (in line with governance recommendations made earlier).
	4.2	Introduce competitive benchmarking, to provide an independent assessment of cost structures and efficiency

	4.3	Consider possible benefits from merging PPUC and PNCC. If attractive, develop detailed action plan.
5 Centralize sector structure and integrate planning.	5.1	Transfer Energy Office from Ministry of Resources and Development to PPUC. Integrate planning for renewable energy into a single national Medium Term Development strategy.
6 Consider inviting private sector to invest in sector	6.1	Determine the capacity of GOP to finance equipment purchases necessary under the JICA Draft Medium Term Development strategy, or alternative funding options, such as a long term concession for a private sector operator to run one generation plant on a pilot basis. If a decision is made to follow concession strategy then a prerequisite will be development of quantified generation capacity statements, indicative assessment of tariff levels and price escalation clauses (including non fuel costs), and safeguards required by GOP, such as maintenance levels and inspection requirements, as well as guarantees to be offered by GOP to the successful bidder.
	6.2	If revised Business Plan projections from PPUC Board of Directors indicate on going financial losses, after making adequate provision for equipment depreciation and maintenance, and factoring in universal service obligations, then GOP move to inviting a Contract Manager for a three year contract, or offering all electricity supplies on a medium-term (10 year) basis.

57. Costs associated with these recommendations are given at Appendix 5.

4.6 Health and Education Sectors

58. Working Paper 5 considers possible opportunities for greater private sector participation in the health and education sectors. In addition, a much more detailed assessment of sector performance has been provided by the Social Services Consultant.

59. The following goal and proposed action plan focus on increasing the level of private sector participation in the sector; adjusting input costs where necessary, to recognize actual employment inputs, and achieving cost recovery contributions from the private sector where it uses government resources.

Table 11 Health and Education Sectors

Goal: Reduce costs through private sector participation

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost	Timing
1	Open up selected services to private sector	9.0	8.75	8.25	8.68	MOE MOH	Existing	2009
2	Achieve full cost recovery from private sector	7.25	9.5	6.25	8.1	MOH	Existing	2009

Table 12 Health and Education Sectors Proposed Action Plan

Strategy	Action No.	Action
1 Open up selected services to private sector.	1.1	Identify total costs of selected services including bus transport, school lunches and building maintenance
	1. 2	Define safeguards necessary for provision of these services, in particular vehicle maintenance and replacement costs, and safety standards
	1.3	Invite private sector Expressions of Interest in providing these services. Compare these costs with costs of Government provision of services
2 Achieve full cost recovery from private sector.	2.1	Identify fair and reasonable commercial rental rates for space to be provided to private sector operators using government facilities

	2.2	Identify ancillary services to be provided e.g. cleaning, and who is normally responsible for providing these services. Ensure that these services are included in cost proposals
	2.3	Draft simple tenancy agreements, indicating responsibilities of both landlord (Ministry) and tenant
	2.4	Notify tenants of rental decision, and relevant responsibilities of landlord and tenant.

60. The proposed action plan is not onerous. It is expected that it can be completed by existing staff as part of their normal duties. This may mean some short term prioritization of existing responsibilities, but once completed the work will only involve an annual review of arrangements.

61. If the private sector Expressions of Interest indicate that they can undertake school transportation and/or lunches at a lower cost, then some additional work on defining contractual terms and conditions will be required. This will not require complex contracts, and should be within the capacity of existing staff to complete the necessary work and provide ongoing supervision.

4.7 Malakal Port

62. Working Paper 6 discusses opportunities for improvement in the current situation relating to Malakal port.

63. The port already operates as a "landlord port" with stevedoring operations on a now expired concession, which is being renewed on a month by month basis. The basis for determining payments by the concessionaire could not be ascertained at the time of the study, because contract documents were unavailable. However, it is known that GOP is not reimbursed for services it provides relating to port security.

64. The fact that the concession has expired means that this is an excellent time to negotiate additional terms and conditions associated with a short term (3 – 5 years) extension of the concession, to provide both Koror State and the concessionaire greater certainty in planning investments and operations, and to allow time for more detailed assessments to be made of alternative port facilities at other locations at Peleliu or Ngardamu. Any plans for new port(s) are likely to have significant economic and social impacts, which will require careful examination, as will associated logistical implications.

65. In view of the limited time frame involved, it is not envisaged that competitive bidding for the concession should take place. However, the opportunity should be taken to secure cost recovery for services provided by GOP, as well as market rates for land use provided by Koror State.

66. There are no regulatory controls to prevent abuse of the monopoly position held by the operator, or any future operator, in terms of stevedoring charges for handling cargo.

67. The rankings provided below are those of the consultant, not the PSC, since the diagnosis or port requirements had not been completed at the time of the presentation to the Committee.

Table 13 Malakal Port

Goal: Short term security of supply

Ref. Number	Strategy	S (25%)	I (50%)	D (25%)	Overall Priority (Rank)	Responsibility	Cost USD	Timing
1	Improve Cost Recovery	7.0	9.0	6.0	7.75	Koror State MOF MOCT	Existing	2009
2	Introduce Safeguards relating to monopoly position	8.0	8.0	8.0	8.0	MOF MOCT	$41,500	2009
3	"Gain time" whilst future port requirements are evaluated	9.0	8.0	7.0	8.0	Koror State	Existing	2008 - 09

Table 14 Port Action Plan

Strategy	Action No.	Action
1 Improve Cost Recovery.	1.1	Identify costs of all services associated with the port and port operations, including navigation aids, infrastructure (wharf etc), dredging, and port security.
	1.2	Identify infrastructure that the concessionaire is responsible for maintaining, and obligations, if any, to maintain this in serviceable condition.
	1.3	Clarify ownership of this infrastructure, and its market value, for consideration if extension of the concession cannot be extended by mutual consent.
	1.4	Clarify which charges are responsibility of port operator (concessionaire) and which are the responsibility of ship owner. (For instance, cost recovery for dredging or maintenance of navigation aids may fall outside the concession contract, if it is only for stevedoring).
	1.5	Produce proposed payment schedule from concessionaire to Koror State and GOP to cover extension of concession.
2 Introduce Safeguards	2.1	Obtain samples of legislation relating to other port operations

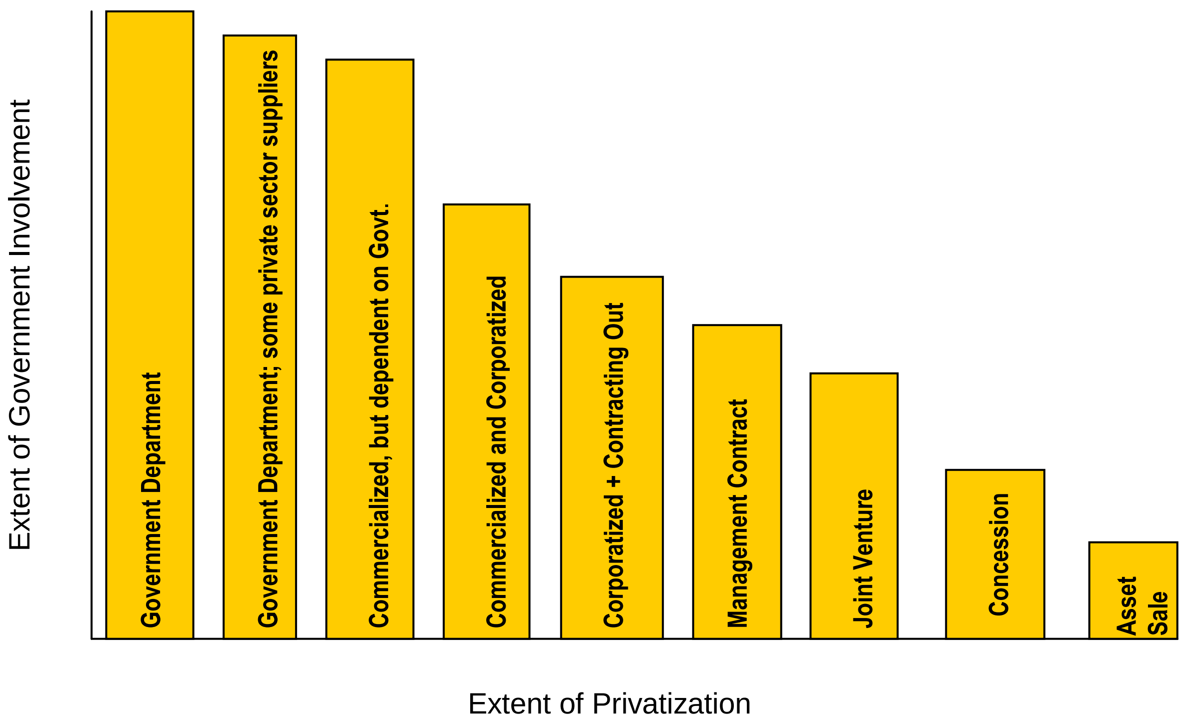
relating to monopoly position	2.2	Develop regulatory regime and pass necessary legislation, including policies on tariffs and cost recovery that will apply to all future service providers. The regulatory regime will include reference to equipment maintenance.
	2.3	After consultation with concessionaire, incorporate regulatory framework into contract conditions to ensure protection against monopoly abuse.
3 "Gain time" whilst future port requirements are evaluated	3.1	GOP and Koror State to reach agreement on cost recovery elements for future tariffs.
	3.2	GOP to make policy decision on timing for any detailed feasibility study for new port(s), and the time frame required to complete such a study. This will influence (i) Koror State planning for extension of concession; (ii) the duration of contract extension, which should correspond to any future development of alternative or replacement port: (iii) the attractiveness of Malakal port for future investment by the concessionaire
		If policy is to consider development of an alternative port, then negotiate extension to existing concession, but with the introduction of full cost recovery for all services provided, recognizing that the port operator will incorporate any such charges into the stevedoring rates charged to cargo owners and ship owners. The duration of the contract extension is to be sufficient to allow for completion of feasibility study and associated policy decisions and development of a new port(s). If the policy decision is to defer consideration of an alternative port then consideration should be given to competitive bidding for longer term operating rights. This will require a more detailed action plan.

68. Costs associated with these recommendations are provided at Appendix 5.

5. An abridged Theory on Privatization Concepts

69. Privatization is interpreted in many ways. The ultimate form of privatization is asset sales. At the other end of the continuum the first steps involve introducing commercial principles and corporatization to government activities, as indicated in the following figure.

Figure 1 Privatization Continuum



70. The concept underpinning privatization is the frequently demonstrated evidence that the private sector is more efficient than government institutions at delivering services to the public. The underscoring philosophy is that government and the private sector each do what they do best. The business of government is government, not business.

71. The "privatization continuum" illustrated above commences with the "no privatization" case – the operation of a government department, with no financial performance incentive, and often little or nothing in the way of performance incentives. Within Palau, BPW falls into this category.

72. The first step to improving performance is often contracting out some low level work, such as maintenance, when the private sector has clearly demonstrated that it can fill these functions at a lower cost than alternative government institutions.

73. **Commercialization** represents the second step along the privatization path. The activity in question is seen to have a financial potential, and profitable performance becomes more important. Greater attention is paid to tariffs and cost recovery, and financial performance becomes a factor in overall governance. However, the institution remains under the direct control of the appropriate Ministry, and there is no wider oversight of planning and operations similar to that provided by a Board of Directors. Opportunities for political directives or

interference remain high. The Palau International Airport fits within the early stages of a commercialized classification, but also demonstrates the drawbacks from partial commercialization, with no single institution accountable for financial performance; tariffs that have not been adjusted to reflect better cost recovery targets, and no unified point where financial results and forward plans can be assessed.

74. **Corporatization** becomes the first real step towards privatization. It emulates private sector conditions, whilst retaining government ownership. It may be as far as governments are prepared to go. There are numerous examples of corporatized government institutions which will never be privatized, because they are seen as strategically important assets, or because of a reluctance on the part of citizens to "sell the family silver". There are other examples of corporatization being the first step to full privatization through a share floatation or asset sale.

75. Corporatization involves some important governance changes:

i) The newly formed Corporation is expected to be run as a successful (profitable) business;

ii) Control moves away from the Ministry, and neither the Ministry or elected representatives can give directions to the new Corporation;

iii) An independent Board of Directors is appointed, with their selection being designed to provide a mix of essential skills e.g. finance, marketing, production, technical legal, etc.;

iv) Government is the shareholder, on behalf of the citizens. Although the Government is the shareholder, the opportunities for Ministerial or political influence on activities are, at least in theory, removed;

v) The Corporation pursues only commercial objectives. If government wishes it to follow social objectives, such as support for low income families, then these are the subject of negotiated and fully transparent subsidies that are reviewed annually;

vi) The Corporation is required to provide annually to the shareholder a Business Plan setting out objectives, cash flow and investment plans in detail for the following 12 months, and in more general terms for the two years after that. This plan is often termed the Statement of Corporate Intent;

vii) The Annual Business Plan is scrutinized on behalf of the shareholder, typically by officials within the Ministry of Finance. They are able to check the plan for compatibility with national economic objectives; for proposed changes in the scope of business; for potential investments that could impact the financial performance of government; for performance against targets over the previous 12 months; for assumptions underpinning financial projections; for dividend policy etc. The Ministry can require additional explanations, and provide a commentary on the plan to elected representatives. It cannot change the plan. Only the shareholder (or the Board of Directors) can do that;

viii) The Annual Plan becomes a public document, presented to the elected representatives after scrutiny by the Ministry of Finance, in the same way that a publicly owned company presents its reports to an Annual General Meeting of Shareholders.

76. Two Palau corporatized institutions have been included in more detailed commentaries included under this Technical Assistance – Palau National Communications Corporation (PNCC) and Palau Public Utilities Corporation (PPUC). Based on these diagnoses, it is suggested that the GOP have followed the form, but not the full processes, of corporatization. In particular:

i) The “review” process for Annual Plans has not been rigorously followed, if it has been followed at all. One consequence has been that PPUC is reported to have consistently budgeted for operating losses, with no obvious corrective action plan being instituted. This comment is based on other consulting reports only. Despite many requests PPUC over many months PPUC did not provide a copy of their plans;

ii) Directors appointments appear do not appear to have been based on providing a balanced mix of skills required to give the necessary quality of governance necessary for a significant corporations;

iii) PPUC, and, to a lesser extent, PNCC have been charged with pursuing social objectives – the former based on verbal statements by the Chief Executive Officer that they aim to break even, and the latter because of the obligations placed on it by government to meet universal service obligations.

77. Followed correctly, corporatization can be a powerful model to ensure cost efficient service delivery. It is not then necessary to move further along the privatization continuum unless government has additional objectives, such as raising finance from an asset sale; further increasing efficiency through a greater level of private sector expertise in the sector, or using the private sector to provide the financial inputs for new capital expenditure needs.

78. **Corporatization with contracting out** is a smaller incremental change in the privatization continuum. Some newly corporatized entities have realized that they cannot fully utilize all staff, and have chosen to outsource some activities on a contract basis. Frequently the outsourcing is to existing staff, who set up as independent institutions of one form or another, and contract their services to their former employer, and also to other buyers. The original employing corporation wins from reduced costs; the availability of important skills and institutional knowledge necessary to be effective. The former employee gains by receiving a guaranteed market, at least in the short term, and the ability to increase revenue from additional sources.

79. **Management Contracts** occur when a government concludes that it lacks the expertise to manage a particular operation, and employs a specialist to provide the necessary guidance and decision making. The contract is usually for the short-term (say 2 – 3 years); involves a “turnaround” situation to improve performance, and links achievements to remuneration or bonuses. For a management contract to be successful it is important that the contract manager be given authority to act, and be not impeded by Ministry or political interference. Palau has some experience with contract management – for instance with PPUC soon after its formation.

80. Under a management contract model the government provides all financial assistance, and retains control over tariff levels and future investment plans. A Board of Directors may be appointed – but this can restrict the ability of the Contracted Manager to turn around the organization based on industry knowledge, experience and expertise.

81. **Joint Venture (JV) Companies** represent a more significant step along the privatization continuum. Usually formed when governments are planning to introduce major new infrastructure, such as water supply systems, a government forms a JV with an experienced operator when it wishes to introduce additional expertise and, probably, finance with operations planned for the long term. The successful proposer and the government jointly establish a new registered company, with both parties holding shares. A Board of Directors is appointed, with representatives for both parties. Capital injections are made in proportion to

ownership share (although with some JVs – for instance in tourism development – the government contribution has been more in the nature of goodwill and guarantees that it will expedite approval processes). The Directors report directly to their shareholders representatives and provide governance in the same way that Directors of any private sector company do.

82. The first benefit of a JV is that the government can select a development partner with appropriate industry expertise, usually after a competitive bidding process. The second benefit is that the private sector will assist with funding any infrastructure investments, thus reducing level of government financial investment in infrastructure. In some cases the private sector capital injection can be linked to tied grants from their domiciled country, while beneficiary government may be able to secure concessional insurance through the Multilateral Investment Guarantee Agency (MIGA) – part of the World Bank Group.

83. JVs are still likely to require a contribution from the partnering government to finance infrastructure purchases. To be financially viable they must also address issues of full cost recovery; the exclusion of social objectives from business objectives; and cross subsidies between different business lines. However, they can be very effective in increasing management capacity, and in ensuring early delivery of services which might otherwise be beyond the financial reach of a government in the short term.

84. **A Concession** exists when the government grants exclusive rights to a private sector institution to provide specific services. The concession is usually for the long term, as represented by life of the infrastructure. The concessionaire may take over existing government infrastructure, or finance and construct specific infrastructure that is considered necessary. In some cases a concession may create a monopoly – for instance an airport. In other cases there may still be competition between multiple concessionaires – as is the case where there are concessions on berths within ports, but with multiple concessionaires co-existing within a port.

85. The presence of private sector operators introduces competition and lower costs, but government must be sure that infrastructure is maintained to a standard specified within any concession documents, and that there is no abuse of monopoly power where this might occur.

86. Malakal port is a Palauan example of a concession. Without access to the concession documents it appears to be what is termed a “landlord” port, where the concessionaire is fully responsible for the provision and maintenance of infrastructure. To the extent that the State has provided some infrastructure, such as the wharf, then there should be adequate inspection mechanisms and clearly delineated responsibilities for maintenance. Malakal port is also an example of a monopoly concession, since the alternative port sites do not offer competitive facilities, with no regulation to prevent abuse of monopoly power. This is an undesirable situation, that is discussed in Working Paper 6 on port privatization.

87. **Build-Own-Operate (BOT), Build-Operate-Transfer (BOT) and Build-Own-Operate-Transfer (BOOT)** schemes are all representative of concession models in which the private sector is funding infrastructure investments, for which it receives exclusive rights of access to markets. The differences between these models is apparent from their names. All three models have the advantage that the private sector finances the cost of new infrastructure and provides the necessary management and operational expertise. The government receives royalty payments, usually linked to production, or benefits from competitive subsidy payments

to the operator in those cases where tariffs are insufficient to cover all operating costs, including depreciation.

88. The keys to success for these models are:

i) To have clearly defined and quantified the objectives of the introduction of any concession, BOO, BOT, or BOOT;

ii) to be completely aware of likely levels of demand;

iii) to fully understand the existing cost structure, including opportunity cost of forgone maintenance etc.;

iv) To have a well targeted policy relating to subsidies and servicing unprofitable locations;

v) to recognize where neglect of existing infrastructure may require significant upgrading, and the likely costs of doing so;

vi) to understand consumer ability and willingness to pay tariffs necessary for a sustainable long term operation;

vii) to have a strong ongoing public information campaign, so that citizens are aware of changes being made – especially if they affect employment levels; and

viii) to have a governance program in place to monitor how well the operator is fulfilling contractual commitments.

89. **The consultant suggests** that GOP consider BOO concessions for new projects such as the landfill site which will require major injections of finance to establish the necessary infrastructure.

90. **Public-Private Partnerships** (PPPs) tend to be interpreted in two ways: (i) contractual arrangements with the private sector, where investment and risk are shared between the contracting parties, and, more precisely (ii) those situations where the private sector invests in infrastructure and manages facilities and services, but with government guaranteeing minimum levels of utilization or revenue, under a “take or pay” clause. Although the government does not provide financial investments under the PPP it does incur long term liabilities. PPPs are at times signed between local or State governments and the private sector. Difficulties have arisen when the government party has been unduly optimistic in its forecasting, and then unable to meet its contractual obligations to make good the shortfall. The national government is then faced with the question of whether it has an implicit liability to make good any shortfall.

91. Despite this risk, PPPs have benefits. As is the case with BOOs, BOTs and BOOTs, government does not have to contribute to the cost of new infrastructure, and, based on a careful selection process, it can be sure that the country receives the benefit of industry experts to manage operations.

92. Long run costs are therefore more likely to be optimized. This does not necessarily mean that tariffs can be reduced. Where current tariffs do not cover full operating costs (for instance, depreciation on some PPUC generator engines) then these will need to be factored in to future operating models. If government wishes to maintain tariffs at below cost, then it will need to enter into subsidy arrangements with the operator. The alternative – and preferable arrangement – is that it targets subsidies at those in the population most in need, rather than providing a subsidy which benefits both rich and poor.

93. **Asset Sales** are the ultimate step in privatization. In these circumstances a specific institution is offered for sale. A variety of modalities can be used – public offering; private offering; sale of assets; and management / employee buyout being the most popular methods. Full privatization involves sale of 100 percent of the institution. However, many governments have been reluctant to go this far, and "privatization" has only been a partial sale. In other cases governments have moved down the concession path, and retained the assets themselves, with operations moving to a lease basis or some alternative form of operating concession.

94. In a number of countries the experience of asset sales has been less than satisfactory as the new owners have purchased the operation at a low price in order to obtain assets, especially land, but not use them in ongoing operations of the business. Any government privatizing a going concern should ensure that it has valued all assets.

95. Asset sales are not considered particularly appropriate for Palau at this time.

96. Within the alternative models of what can broadly be described as privatization, Palau has a number of different positions. For instance, BPW remains as a Government Department, while both PNCC and PPUC are corporatized entities. Malakal port is a full concession, under the State of Koror. Figure 1 on the following page illustrates the scope of different interpretations or modalities of what is often grouped under the broad title of privatization.

97. **Palau has partly implemented a corporatization strategy, both in terms of scope and governance processes.** For instance, PNCC and PPUC are both corporatized institutions. However, the best practice model has not been replicated completely**. What is missing in Palau is the feedback link between the Government, as shareholder, and the Board of Directors.** In other successful models a government Ministry – typically the Ministry of Finance – reviews the Business Plans of the corporatized institutions, and periodically – at least every six months – compares actual performance against plan. The Ministry will consider alignment of Business Plans with national objectives; proposed investments and the associated rate of return, and any proposed changes in the scope of business. The Ministry is not empowered to change the Business Plan. It can refer queries back to the Board of Directors, and it is responsible for providing a commentary on the Business Plan and actual performance to elected representatives.

98. The Ministry involvement introduces a strong element of accountability of the Board of Directors to the Government. It provides the opportunity for informed comment, and independent, expert scrutiny. A proposed strategy is to increase the oversight of government owned corporations in Palau. One suggested action as part of this strategy is for Ministry representatives to visit, say, the Crown Company Monitoring and Advisory Unit (CCMAU), in New Zealand (part of the Ministry of Finance) to discuss the practical application of this concept.

99. The team will then discover that one other important function of CCMAU is to identify the skill mix necessary in Boards of Directors, and to identify candidates that match these criteria.

6. Regulatory Frameworks

100. As discussed in a number of Working Papers, one of the underpinning philosophies behind corporatization and privatization is to establish government institutions as successful businesses. A corollary is that they operate as efficiently as similar private sector businesses. If this philosophy holds true, then government institutions should be able to compete with private sector providers.

101. PNCC demonstrates how this holds true exists within Palau. Private sector competition does exist; PNCC responded to its entry by lowering its prices, and continues to make a profit. However, as suggested in the Working Paper and the proposed goals and strategies in this Paper, PNCC is also at a competitive disadvantage, since it is required to meet universal service obligations and to repay the costs of past sector debt covering the whole country, while private sector competitors can “cherry pick” the market and service only high density segments. A regulatory framework that ensures a level playing field has therefore been recommended.

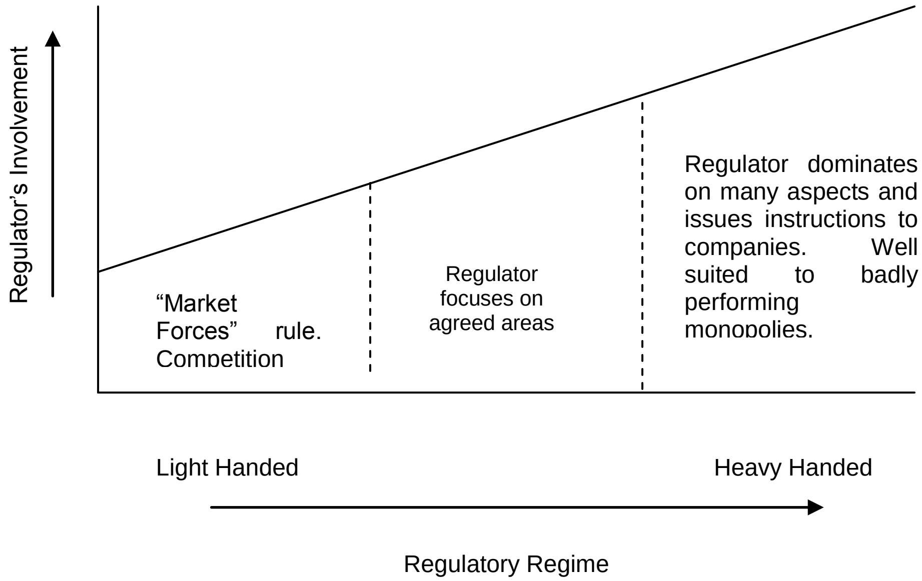
102. Regulatory frameworks are also desirable where government is at present the monopoly provider, but there is scope for future private sector participation. In these cases (and Malakal port can be considered one such example) regulation is needed to prevent later abuse of monopoly or dominant position in the market.

103. Regulatory frameworks have therefore been recommended to enable the private sector to participate in the electricity sector, and to provide protection against possible future abuse in port operations. Palau International Airport is also a monopoly, under government control. In this case the need for regulation is considered to be less pressing, unless private sector management is introduced. The proposed governance mechanisms are thought to provide enough protection in the short term.

104. Adequate regulatory frameworks – or at least strong contractual conditions – are also important where the private sector is using or providing infrastructure that has a medium to long term life. It is very easy for the private sector (and, as suggested in some of the preceding commentaries, government institutions) to increase profits by deferring maintenance. Contracts for service provision by the private sector therefore need to consider safeguards to ensure that there is adequate maintenance, and an inspection regime to ensure compliance with this requirement.

105. One final consideration relating to regulation is the nature of the regulatory framework. This is a policy issue. Regulatory frameworks can be broadly described as “light handed” through to “heavy handed”. Light handed regulations rely on market forces and competition to provide protection against abuse of a dominant position; heavy handed regulations involve much higher levels of government oversight and control, and therefore higher supervisory cost levels. The figure below illustrates the characteristics of different regulatory regimes.

Figure 2 Regulatory Frameworks



7. Subsidy Policies and Universal Service Obligations

106. Reference has been made in a number of cases to subsidies. These include implicit subsidies, where full cost recovery does not apply, or where some costs (for instance labor in the case of BPW Facilities and Maintenance group) or failure to cost in equipment depreciation; and cross subsidies between business lines (for instance, to enable low density areas to be provided with telecommunications and electricity).

107. As discussed, corporatization will not deliver optimum results if the enterprise is required to deliver both social and commercial objectives where they are conflicting and not well defined. Still less will it succeed in competition in cases, such as PNCC, where the GOP corporation is required to meet universal service obligations, which require internal cross subsidization, but there are no similar impositions on private sector competitors.

108. Effective subsidies are targeted, for instance to reach those lacking the ability to pay and are subject to regular review to determine there cost effectiveness. They are fully transparent, so that government is aware of the associated cost – for instance providing electricity to small communities using excess capacity. Government can then review and negotiate the level of subsidy it can afford to pay each year. These requirements are not met at present.

109. The private sector may well be interested in providing services where production costs exceed revenue. In these circumstances any higher level of private sector involvement is based on the level of subsidy payment from the government to the operator, rather than a concession fee from the operator to government (in the case of a monopoly). The bidder requiring the lowest subsidy, but still meeting required service standards, is successful.

8. Employment Policies

110. Productivity improvements and public sector reform often has employment implications. In the past GOP has had a "reduction in force" policy, but this is not active at present. It is suggested that GOP has obligations to its employees to provide them with fair and reasonable opportunities for future employment outside government, and that policies in this area need to be reconsidered and reactivated. Relying on natural attrition is a slow way of increasing employee productivity.

111. It should be noted that simply corporatizing an operation, and not addressing management capacity and processes, is not by itself likely to improve performance significantly. Management and all employees must be provided with the leadership necessary to improve the way they have done things in past.

9. The Enabling Environment

112. If the private sector is to be encouraged to enter markets that have traditionally been exclusive to government then it will be necessary to ensure that these markets are attractive and offer the potential to achieve an adequate return on investment. Restrictions on market entry must be reviewed, and, where possible, removed. Greater certainty that the policies allowing private sector participation – in particular through adequate contract duration – will be important considerations, if the private sector operator has to invest in plant and equipment, and training a skilled workforce. It is not sufficient to say, as has been suggested "we can try it and if it doesn't work go back to doing it ourselves".

113. Any bidding process must be based on adequate data relating to future work volumes, and risks. For instance, as two examples, water supply concessions in some USA cities collapsed when it became apparent that the cities had failed to appreciate the level of water losses through poor quality distribution, and the private sector found their revenues were inadequate to cover these losses. Electricity generation in a State in India ran into serious difficulties when the State Government single buyer continually deferred payment for electricity generation because of cash flow difficulties.

114. Domestic competition with low barriers to entry – for instance in Facilities and Maintenance – is likely to be a successful initial strategy that will help demonstrate the extent to which the private sector can reduce total costs for GOP. The goals and strategies proposed in this Working Paper are intended to provide an incremental approach where possible that will demonstrate the successes that can be achieved.

115. In some areas, such as road maintenance, care may be needed to ensure there is no monopoly supply situation, such as asphalt supply, that gives any single private sector supplier a monopoly position. This can be addressed through the contract structure.

10. "Think Like the Private Sector"

116. Government has the capacity to act like the private sector. All too often they do not do so.

117. Some of the key tactics to improve performance that can be adopted by all institutions studies include:

i) Target high cost areas;

ii) Discontinue unprofitable activities (or negotiate a subsidy to enable these to continue);

iii) Sell off surplus assets; and

iv) Eliminate all non value added activities through a process of Business Reengineering.

11. References

FEIM 2008a, Privatization and Corporatization Options for Palau National Communications Corporation, Working Paper No. 1.

FEIM 2008b, Privatization Options for Palau International Airport, Working Paper No. 2.

FEIM 2008c, Privatization and Corporatization Options for the Bureau of Public Works, Working Paper No. 3.

FEIM 2008d, Privatization and Corporatization Options for Palau Public Utilities Corporation, Working Paper No. 4.

FEIM 2008e, Privatization and Corporatization Options for Health and Education, Working Paper No. 5.

FEIM 2008f, Strategic Options for Private Sector Participation in Port Services, Working Paper No. 6.

FEIM 2008g, Position Paper on Public-Private Partnerships in the Delivery of Government Services, Working Paper No. 8.

Appendix 1 Overarching Goal Project Costing

Goal: Improve Quality of Governance of Public Enterprises.

Table 15 Project Costing USD

Item		Number	Unit	Rate	Total
1.2	Specify Delegated Authorities		Lump Sum		10,000
1.5	Study Tour on Governance Oversight	5	People		
	Air fares	5	Trips	2,500	12,500
	Per Diem	35	days	200	7,000
	Miscellaneous travel		Lump Sum		1,500
	Contingency				1,000
	Sub Total				22,000
1.8	Performance Monitoring system		Lump Sum		10,000
3.1 - 3.2	Regulatory Study				
	Consulting Time	4	Months	20,000	80,000
	Air fares	3	trips	2,500	7,500
	Per Diem	120	Days	160	19,200
	Miscellaneous Travel		Lump Sum		600
	Contingency				1,700
	Legal Drafting	4	Months	15,000	60,000
	Sub Total				109,000
	Total				151,000
Other	All other costs are assumed to be covered by existing salary costs and overheads.				

(Note: The proposed regulatory study is additional to the regulatory study proposed for PNCC.)

Appendix 2 PNCC Project Costings

Proposed Goal: Ensure Palau retains the leadership position in Information and Communications technology, thus increasing the attractiveness of PNCC to private sector investors.

Table 16 PNCC Project Costing USD

Item		Number	Unit	Rate	Total
1.1 - 1.3	USO study/Regulatory Framework				
	Consulting Time	2.25	Months	20,000	45,000
	Air fares	2	trips	2,500	5,000
	Per Diem	75	Days	160	12,000
	Miscellaneous Travel		Lump Sum		500
	Contingency		Lump Sum		1,500
	Sub Total				64,000
4.2	Introduce benchmarking				
	Consulting Time	1	Months	20,000	20,000
	Air fares	1	trips	2,500	2,500
	Per Diem	30	Days	160	4,800
	Miscellaneous Travel		Lump Sum		200
	Contingency		Lump Sum		1500
	Sub Total				29,000
	Total				93,000
Other	All other costs are assumed to be covered by existing salary costs and overheads.				

Legal Drafting not included, since this is to develop policy recommendations. If drafting is included an additional $60,000 should be provided

Appendix 3 Palau International Airport Costings

Proposed Goal: Develop Palau International Airport into fully self funding operation.

Table 17 Palau International Airport Costing USD

Item		Number	Unit	Rate	Total
2.1 - 2.4	Improve management capacity				
	Consulting Time	1.5	Months	20,000	30,000
	Air fares	2	trips	2,500	5,000
	Per Diem	45	Days	160	7,200
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		1,400
	Sub Total				44,000
3	Corporatization				
	Consulting Included Above				
	Directors Fees	50	Meeting	250	12,500
4.1	Introduce benchmarking				
	Consulting Time	1	Months	20,000	20,000
	Air fares	1	trips	2,500	2,500
	Per Diem	30	Days	160	4,800
	Miscellaneous Travel		Lump Sum		200
	Contingency		Lump Sum		1,500
	Sub Total				29,000
	Total				85,500
Other	All other costs are assumed to be covered by existing salary costs and overheads.				

Appendix 4 Bureau of Public Works Costings

Proposed Goals:

1. **To significantly increase productivity and efficiency; and**
2. **identify appropriate funding and service delivery mechanisms for future services.**

Table 18 Bureau of Public Works Costing USD

Item		Number	Unit	Rate	Total
1.1 - 1.5	Improve Business Plans				
	Consulting Time	1.5	Months	20,000	30,000
	Air fares	1	trips	2,500	2,500
	Per Diem	45	Days	160	7,200
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		1,400
	Sub Total				41,500
2	Regulate Standards				
	Consulting Time	1.5	Months	20,000	30,000
	Air fares	1	trips	2,500	2,500
	Per Diem	45	Days	160	7,200
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		1,400
	Sub Total				41,500
3	Road Asset Management System		Requires costing		
4.3 - 4.4	Breakeven and tariffs	Presume to have been addressed in JICA studies			
5	Outsourcing				
	Consulting Assistance	1.5	Months	20,000	30,000
	Air fares	1	trips	2,500	2,500
	Per Diem	45	Days	160	7,200
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		1,400
	Sub Total				41,500
6	Assess interest of private sector in providing solid waste management				
	Consulting Assistance	3	Months	20,000	60,000
	Air fares	2	trips	2,500	5,000
	Per Diem	90	Days	160	14,400
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		2,200
	Sub Total				82,000
	Total				206,500

Other All other costs are assumed to be covered by existing salary costs and overheads. Regulations can be drafted and promulgated internally.

Appendix 5 Malakal Port Costings

Goal: Short-term security of supply.

Table 19 Malakal Port Costings USD

Item		Number	Unit	Rate	Total
2.2	Introduce Regulatory Regime				
	Consulting Time	1.5	Months	20,000	30,000
	Air fares	1	trips	2,500	2,500
	Per Diem	45	Days	160	7,200
	Miscellaneous Travel		Lump Sum		400
	Contingency		Lump Sum		1,400
	Total				41,500
Other	All other costs are assumed to be covered by existing salary costs and overheads.				