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BACKGROUND PAPER ON ENERGY POLICY AND INSTITUTIONAL REFORM

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I. INTRODUCTION

The need for policy and institutional reform in the energy sector is recognized by the GOP as well as by USAID and the major multilateral donors. Considerable progress has already been achieved during the past three years. Much of the analytical work needed prior to bringing about such reform is complete and important initial steps are already taking place. Moreover, there is broad consensus within the GOP and among the donor community on the shape and content of the energy policy and institutional reform agenda that needs to be followed for the rest of this decade and into the 1990s.

The discussion below details the major items on this agenda. It begins with an overview of the existing situation, describing the role of energy in Pakistan's economy, reviewing the institutional setting and analyzing major policy constraints. The following section outlines in more specific terms USAID's own priorities for energy reform. A concluding section describes approaches planned for bringing about policy and institutional reform in the energy sector during the post 1987 period.

II. OVERVIEW OF THE ENERGY SECTOR

A. The Role of Energy in Pakistan's Economy

Energy receives the highest priority under the GOP's current Sixth Five Year Plan (1983-1988), with about 40% of all development resources targeted toward this sector. This emphasis reflects energy's important position on the critical path to economic development in Pakistan. Despite widespread natural gas and electricity load shedding, energy consumption increased at an annual rate of nearly 10% between 1978-1979 and 1983-1984, while electricity use grew by nearly 13%. Economic growth during this same period averaged about 6% a year.

Hydro-power and natural gas are Pakistan's two main commercially exploitable energy sources, followed by coal and crude oil. In addition, there are large quantities of non-conventional energy sources such as firewood, crop residues, and animal wastes. Total energy consumption during PFY1984 was equivalent to 25 million tons of oil, of which one-third was met from non-conventional sources. Imports--primarily oil and related products, which represented about half the value of Pakistan's exports--accounted for 36% of total commercial energy supply. Energy demand outstrips supply and is expected to continue to do so far at least the rest of the 1980s.

GOP figures indicate that about 30% of Pakistan's commercial energy goes to industry, 19% to transportation, 19% to households and businesses, and 5% to agriculture. While underscoring industry as a major user and the sector most affected by fluctuations in energy supply, the statistics seriously understate energy's overall contribution to the agricultural health of the country. Adequate electricity is needed to power about 150,000 agricultural tubewells (an estimated 30% of the total electricity generated by WAPDA is used for tubewells), while fuel oil is important both for diesel driven tubewells and for tractors and other farm machinery. In addition, the aggregate figures do not show the broad impact energy use in industry and transportation has on agriculture. One-third of Pakistan's natural gas is used in fertilizer production, while the large agricultural processing industry is dependent on adequate energy supplies. Adequate fuel supplies are also important in insuring that agriculture produce is shipped to market on time, while the introduction of electricity greatly affects the quality of life in Pakistan's villages.

Continued failure to meet growing energy demand is seriously affecting economic development in Pakistan. Annual shortfalls in power generation and natural gas are already a major problem that is curtailing factory operations and reducing supplies of tubewell water for irrigation. Generating capacity increases under the Fifth Plan (1978-1983) were only 60% of target figures, and most Sixth Plan projects are seriously behind schedule. It is very likely that energy shortages are leading to substantial increases in production costs, while uncertainty about energy availability restrains private sector investment, especially in large-scale manufacturing. Causes for these shortages can be traced to planning deficiencies, highly centralized project authorization requirements, dependence on government subsidies and government-negotiated loans, and overextended management.

B. Institutional Setting

Responsibility for energy planning and development is shared by numerous government ministries and public-sector agencies. Private sector participation is limited mainly to oil, gas, and coal. Major actors on the policy front include the Ministries of Finance, Planning and Development, Water and Power, and Petroleum and Natural Resources. Public-sector delivery institutions include the Water and Power Development Authority (WAPDA) and the Karachi Electric Supply Corporation (KESC) for power, the Oil and Gas Development Corporation (OGDC) for oil and gas, the Pakistan Mineral Development Corporation (PMDC) for coal, and the Director General of Energy Resources (DGER) and the Appropriate Technology Development Organization (ATDO) for renewables. Bureaucratic rivalries often limits cooperation among agencies. Lack of integration also makes coordination difficult, leading to duplicated efforts or, on occasion, failure of any one institution to take needed initiatives. In addition, this fragmented approach makes it difficult to elevate energy concerns to the highest policy-setting levels of the GOP.

Poor operational efficiency within the more specialized delivery institutions is caused by several factors, including overstaffing, inefficient management, inadequate funding, and limited autonomy. For example, the customer to employee ratio in WAPDA's distribution section is 52 to one compared to 300-500 to one in most electrical utilities, including many in other developing countries. While staffing levels are ordinarily not a problem, quality of staff often is, largely because there are few performance incentives needed to attract and keep qualified personnel. Inadequate funding, especially for operation and maintenance activities, is also a problem in nearly every public sector organization. Finally, public delivery institutions such as WAPDA, KESC, and OGDC need to be given more autonomy in order to improve their self-financing capability and strengthen their planning and implementing capacity.

Private sector institutions are not as strong as they should be, in part due to policies during the 1970s which discouraged or prohibited such participation in several energy sub-sectors. Nationalization of key industries had an especially "chilling" effect and continues to color to some extent private sector attitudes toward the GOP. Nevertheless, a private sector capability does exist, especially in coal and oil and gas development. Involvement in all these areas needs to be expanded, along with participation in power generation and energy conservation measures. The need for building on private sector efficiency and resource mobilization strengths was explicitly recognized by the GOP under the Sixth Plan, and the private sector is expected to play an increasingly important role in meeting Pakistan's future energy requirements.

C. Policy Constraints

Pakistan's energy policy framework stems largely from the post 1973 period, when the international energy crisis led to major structural changes in the world economy. Pakistan's dependence on oil imports for most of its commercial energy needs made it one of the countries most affected. Initial policy responses emphasized arranging credits to finance mounting oil import bills and, at the same time, increased supplies of indigenous natural gas at prices well below international levels. While understandable as a short term measure, the subsidies led to inefficient energy use and only postponed for a decade the more painful adjustments required to bring domestic energy prices in line with international levels. Given the recent fall in world energy prices, a historic opportunity now exists to bring about needed pricing changes as well as reforms in energy planning, conservation, and other areas.

1. Pricing: Economically determined pricing is ordinarily viewed as the key policy tool in achieving allocative efficiency in the energy sector. On the demand side, it reduces waste and encourages development of more energy-efficient technologies. On the supply side, it encourages

required financial investments and stimulates development of indigenous energy resources. For most oil-importing countries, "import parity" (the difference between domestic prices and border prices) serves as a proxy for determining appropriate tariff structures.

Under a 1981 agreement with the World Bank, the GOP is committed to raising consumer natural gas prices from one-fourth to two-thirds the border price of fuel oil by FY1988. The target figure has nearly been met, due to several price hikes (including an average 50% increase in June 1985) as well as to sharp declines in world oil prices. As for producer pricing, a new policy announced in June 1985 gives producers 66% of the international price of oil at main consumption centers, adjusted for transportation and less a discount to be negotiated. The level of this discount is to be agreed upon before exploration begins, an important distinction because gas finds in the past were seen by the GOP as simply a "byproduct" of oil exploration and the terms for development not fully spelled out.

Electricity prices also do not reflect their real economic cost. They were much lower than international levels throughout the 1970s and remain insufficient to finance the extensive power generation investments needed during the next fifteen years. Both WAPDA and KESC raised rates by 10% in July 1985 and further hikes are expected on an annual basis. As a condition for disbursements under the second tranche of the World Bank Economic Support Loan, WAPDA must finance at least 40% of its investment costs from internally generated funds by FY1987.

Price distortion issues are not only confined to natural gas and electricity, but affect other energy sub-sectors as well. For example, coal development in Pakistan has historically lagged behind, in part because of the difficulties in competing against more subsidized energy sources. Large coal reserves are known to exist in Pakistan, but this major potential source of indigenous energy remains under-utilized. As the gap between government-determined and market-determined energy prices narrows, the demand for coal will almost certainly increase.

2. Planning: The main issue in energy planning is the lack of integration among ministries, committees, and other bodies involved in policy formulation and project coordination, and monitoring. The GOP is now consolidating planning within the Ministry of Planning and Development through ENERPLAN. In a related issue, adequate salary scales and other incentives are needed to insure recruitment of highly qualified staff. The strength of ENERPLAN will be tested early, as it takes responsibility for preparation of Pakistan's Seventh Five Year Energy Plan (1988-1993). The goal is to bring about consistent planning and a core investment program that remains insulated from the fluctuations inherent in the annual budgeting process.

3. Conservation: The gap between energy supply and demand is increasing, leading to more load shedding and declines in industrial production. Deficits in power generation as well as natural gas are expected to reach 18%-20% of peak demand by 1987-1988. Shortfalls can only be accommodated by a combination of increased supply and moderated demand. Full use of the latter option would result in significant energy savings in a relatively short time. According to a report funded by USAID and reviewed by the World Bank and Asian Development Bank (ADB), \$600 million in conservation and efficiency-enhancing energy investments could yield up to \$3 billion in energy savings and \$1 billion in foreign exchange savings by 1992.

Pricing reforms are an important first step toward encouraging more efficient energy use. Other steps are also taking place, including initiation of a national strategy for energy conservation. With USAID support, the GOP has agreed to establish a National Energy Conservation Center (ENERCON) to coordinate conservation activities, formulate policy guidelines, develop a data base, support training, and monitor implementation of a national energy conservation program. Since the need for energy conservation is widely recognized within the GOP and among the donor community, emphasis now is on implementation.

4. Privatization: Pricing reforms are a key element in any privatization strategy and steps by the GOP to raise electricity tariffs and link producer prices for oil and gas to international levels are encouraging. Oil development by Union Texas and Occidental in southern Sind and the Potwar area of Punjab demonstrate the efficiency of private firms area once policy signals are right. (Oil development is one of the "success stories" under the Sixth Plan, and production figures now exceed 40,000 barrels a day, well above the 21,000 target figure set for 1988). Such involvement needs to be extended more fully to natural gas, where dormant fields lie unutilized for lack of adequate investment incentives.

The coal industry is already largely in private hands, in part because of a historic pattern of official disinterest in coal production. New awareness of coal's potential, along with concrete steps taken to increase its use in cement production, power generation and elsewhere, have placed the policy environment in a state of flux. USAID believes the most effective way to develop Pakistan's coal is to continue to rely on the private sector and plans to insure that the new interest in coal does not provide opportunities for the public sector to enter through the "back door." The private sector also has the potential to develop, produce, and distribute coal briquettes to residential users throughout the country.

The field for private sector involvement in power generation is open following a GOP decision to allow private parties to sell electricity to WAPDA and KESC. A number of commercial firms have already expressed interest and preliminary planning is underway. The

institutional framework for implementing and expanding the new policy still needs to be worked out and involves detailed analysis of pricing, contracts, and technical issues. In particular, policies allowing private participation will mean little unless the policy signals are also right. Legitimate WAPDA and KESC concerns over loss of their most lucrative industrial markets also need to be dealt with.

5. Environmental: Environmental considerations figure only marginally in most economic decision-making in Pakistan. However, their importance is certain to increase as coal use rises and industry expands. In particular, implementation of GOP plans for large-scale power generation based on indigenous coal reserves, which are high in sulphur and ash content, will have a significant impact on the environment. Uncontrolled emissions from cement and brick kilns are already a major and highly visible source of air pollution in industrial areas and hazardous waste disposal will become a growing problem as Pakistan's manufacturing sector expands. Environmental degradation in terms of deforestation and salinization is also clearly evident in many rural areas.

Because of these developments, some steps to establish an appropriate environmental planning strategy are underway. The Pakistan Environmental Protection Council (PEPC) was authorized in 1984 but its membership has not yet been named. The Pakistan Environmental Protection Agency (PEPA) was also created at the same time to develop standards and formulate a national environmental policy. It too has not yet been staffed and is awaiting an operational budget. Without official support, these initial efforts to deal with environmental issues will remain in only an embryonic stage.

III. AN AGENDA FOR INSTITUTIONAL AND POLICY REFORM

A.I.D.'s Policy Paper on Energy (July 1984) describes three long-term objectives for its energy programs: (1) development of sound national energy policies that support sustained economic growth; (2) expanded production of indigenous energy resources; and (3) improvements in the efficiency of energy use. The Mission's strategy is designed to achieve all three objectives through a combination of energy investments and policy reforms. Some of these reforms have high visibility and an immediate impact--and tend to be controversial politically, making implementation difficult. Other are more low-key and, though less dramatic, can over the long-term make an important difference in meeting Pakistan's energy needs.

A. Immediate Impact Areas

1. Privatization: Official policy now supports private sector involvement in most energy sub-sectors, including oil, gas, coal, and power. Actual levels of investment depend on additional factors, including pricing reform and bureaucratic responsiveness. At the most basic level, continued progress on price reform is the single best way to increase private sector involvement in oil, gas and coal development. It is also critical in providing sufficient incentive for private sector participation in power generation.

Other policy goals vary, depending on the level of private involvement. With respect to coal, the objective is to insure that the private sector continues to play a lead role, including participation in large capital-intensive projects such as the proposed coal-fired power plant at Lakhra. As for private power generation, official sanctioning will be ineffective unless there is follow-up agreement on ground rules that provide adequate investment incentive. While the World Bank plays a lead role in encouraging expanded private investment in oil and gas, the Mission will assist through discrete initiatives such as funding for a scheme to attract private investors in the development of the Dhodak fields.

2. Electricity Tariffs: Electricity price reform is critical, especially in view of the enormous financing needed to expand the power generation system. The Mission is supporting several studies directly dealing with tariff issues, including studies on service costs, tariff rationalization, power sector subsidies, and the economic and financial costs of load shedding. The Mission also supports the World Bank-GOP agreement under the 1985 Energy Sector Loan to adjust WAPDA tariffs to cover at least 40% of investments averaged over a three-year period. Further increases, though politically difficult, are needed and will receive full Mission support. Annual rate increases of between 10% and 20% in real terms will be required for the foreseeable future to meet these minimal internally-generated investment targets. The higher tariffs will be difficult to sustain unless they are also accompanied by obvious benefits, including a reduction in load shedding.

3. Natural Gas Pricing: Agreement between the World Bank and the GOP has already been reached on raising producer and consumer natural gas prices to two-thirds the border price of fuel oil by PFY1988. Disbursements under the A.I.D.-funded Energy Commodities and Equipment (ECE) program are also contingent on progress in this area. A long-range goal of 100% by PFY1991 has been discussed with the GOP but not yet accepted. It remains a realistic policy objective, especially given recent falls in world oil prices. Once parity is achieved, the link with world prices needs to be maintained to avoid a return to distorted investment and inefficient use patterns.

B. Long-Term Impact Areas

1. Institution Building: The Mission seeks to integrate all institution-building activities within its broader institutional and policy reform agenda. Much of this effort is directed toward establishing a strong planning capability, including the analytical research needed to guide policy reform. In addition, it is important to clearly demarcate those areas where public involvement is appropriate and needs strengthening from those areas better left to private hands. Where political imperatives require public sector institutions, efforts will be made to develop these institutions along more rational and efficient lines. A prime example is the need for more operational autonomy for WAPDA and OGDC, as well as greater fiscal responsibility and authority and flexibility in the self-financing of their expansion. Finally, training and performance incentives (including adequate salaries) are critical in providing technical competence and insuring that qualified staff are recruited as well as retained.

With respect to energy planning, the groundwork for a high-level coordination cell has been laid with the establishment of ENERPLAN within the Ministry of Planning and Development. Less dramatic but no less important steps are needed to insure that the institution is properly staffed, receives adequate funding, and is given sufficient autonomy. The long-term goal is the development of a quality policy-setting energy group with an independent analytical capability.

The Mission also has a long-term commitment to institutional development at WAPDA which includes a broad range of management and operational reforms, especially in the area of power distribution. Key changes being supported by USAID include the establishment of a separate Electric Power Distribution Authority and reform of most power distribution management, administrative and engineering systems and procedures. Private sector participation in the management and operation of the power system is also envisaged.

The Mission has decided against providing long-term support for PMDC, believing that coal development is better left in private hands. However, it does support legitimate exploration activities undertaken by OGDC and Geological Survey of Pakistan (GSP) that are designed to fully assess the potential of Pakistan's hydrocarbon reserves. With respect to the GSP, the Mission is seeking GOP commitment to provide an adequate operational budget. It also plans to develop a geo data center and coal analysis laboratory, provide training, and assist with preparation of a national coal exploration plan. OGDC's status has improved because it is now able to retain a larger share of its own earnings. However, its management and technical capabilities need to be strengthened as it moves toward financial self-reliance and begins to operate more like a commercial concern.

2. Energy Efficiency and Conservation: The importance of a comprehensive energy efficiency and conservation program no longer needs "selling" within the GOP. Pricing reforms are a critical first step to reduce energy waste, but the effort needs to be supported by a thoughtful and analytically sound national energy efficiency and conservation effort. Coordination of such a plan will come through ENERCON, which is being established with USAID support. The GOP needs to provide ENERCON with operational autonomy, adequate funding, and authorization for the personnel incentives needed to attract high-quality staff. Short-term conservation goals include implementation of a program for efficient co-generation, power distribution, and thermal power generation. Feasibility studies, energy audits, and equipment financing are also underway and will be closely coordinated and parallel funded with the World Bank and other donors.

3. Environmental: Environmental planning in Pakistan is in its infancy. In connection with the proposed Lakhra Coal and Power Generation project, the Mission would like to see the GOP develop realistic national environmental standards. The authorized but not yet established Pakistan Environmental Protection Council and Pakistan Environmental Protection Agency are the logical vehicles for such a program, but need support in terms of funding and an official GOP policy mandate to carry out appropriate environment-related activities.

IV. POST 1987 POLICY DIALOGUE STRATEGY FOR THE ENERGY SECTOR

A. Objectives Restated

The Mission's overall objectives for the energy sector are closely linked with its policy and institutional reform agenda, as shown in the matrix below. Individual A.I.D. projects and programs--Rural Electrification (RE), Energy Planning and Development (EP&D), Energy Commodities and Equipment (ECE) and the proposed Lakhra Coal Power and Generation project serve as the main negotiating tools, along with close coordination with other donors which reinforces the impact of policy reform activities.

<u>Energy Program Objective</u>	<u>Key Policy/Institutional Reform Intervention</u>	<u>Negotiating Tools</u>
1. Eliminate electricity load shedding	(a) economically-determined tariff structures; (b) conservation; (c) institutional reform at WAPDA and KESC; (d) greater private sector support for co-generation and power generation	RE, ECE, Lakhra, private sector TA

2. Eliminate natural gas load shedding	(a) economically-determined prices for both producers and consumers; (b) conservation (c) institution-building at OGDC and GSP; (d) private sector to play lead role in development of natural gas	ECE, EP&D, private sector TA
3. Support GOP and USG balance of payment objectives	(a) development of indigenous energy resources, including coal and fuelwood; (b) conservation; (c) private sector resource mobilization	ECE, EP&D, ENERPLAN, ENERCON
4. Increase private sector participation and investments in the energy sector	(a) economically-determined prices for producers; (b) provide "level playing field" to facilitate private investment	ECE, EP&D, private sector TA
5. Increase donor financing in energy sector	(a) improved energy planning; (b) improved donor coordination	RE, EP&D, ECE Lakhra
6. Improved efficiency of energy production, distribution and use	(a) economically-determined pricing policies; (b) conservation; (c) increased private sector participation; (d) stronger public sector energy institutions	ECE, EP&D, private sector TA
7. Strengthen energy sector's institutional, management, and manpower base	(a) increased private sector involvement; (b) stronger public sector energy institutions	EP&D, RE, Lakhra

B. Strategy

The size of A.I.D.'s investments in Pakistan's energy sector ensures the Mission's presence at the policy dialogue table. In some areas, such as conservation and private sector involvement, the Mission plays a lead role; in others, such as pricing, it lends support to multilateral initiatives by the World Bank and Asian Development Bank. Substantial progress has already been made on a range of fronts, including gas and electricity pricing, private sector participation, and institution-building. The post 1987 program will build on these initiatives through a strategy based on special studies, donor coordination, project activities, and formal compliance with specific benchmarks.

1. Special Studies: All policy must be built on a sound analytical foundation that is technically sophisticated and, at the same time, comprehensible and achievable for policy makers. While drawing on relevant experience from elsewhere when appropriate, it also needs to take into account Pakistan-specific political constraints and economic requirements. The need for rapid development in energy as well as GOP policy performance thus far indicates that most energy sector policy recommendations will be accepted if the need for them is properly articulated and the benefits clearly identified.

The macro and micro policy studies which lay the groundwork for effective policy dialogue are worked out in consultation with and at the request of the GOP. Recommendations frequently form the basis for subsequent action. The "menu" of studies now being undertaken is wide-ranging and illustrative of the issues expected to receive high priority during the post 1987 period. Examples in the power sub-sector include an analysis of the Economic and Financial Costs of Load Shedding, a study on the Rationalization of Electricity Pricing, and a masterplan for Power Distribution Rehabilitation and Expansion.

Sound research is only the first of many steps needed in order to bring about effective policy reform. Presentation is also important to ensure that key decision-makers are familiar with research findings and their policy implications. These in turn should be discussed at a national level, an exercise that can more clearly define political constraints as well as reform possibilities. The First National Coal Conference, funded by USAID and scheduled for February 1986, represents one such effort and is expected to publicize a range of coal-related policy research. The participation of both private business and government officials is especially significant, and should strengthen the private sector's role in this important energy sub-sector.

2. Donor Coordination: Donor coordination will continue as an important part of the Mission's overall policy dialogue strategy. The core concern is to maximize impact and, at the same time, ensure that the efforts of one donor don't undercut the activities of another. The Mission will continue to let the World Bank take the lead on pricing issues. The World Bank in turn lends support to A.I.D. initiatives in such areas as energy planning, institutional reform, coal development, and privatization. This informal agreement on burden sharing provides the basis for a powerful and concerted effort to work on a broad agenda of sector reforms in energy and to guard against "divide and conquer" tactics that weaken policy dialogue efforts.

Coordination takes place on both a formal and informal basis and includes multilateral (World Bank, Asian Development Bank) and bilateral (CIDA, ODA) donors. All four agencies were represented at a coordinating meeting hosted by the Mission in September 1985, and similar gatherings are planned on a semi-annual basis. The Mission had an important input

into the World Bank's Energy Sector Loan of July 1985, including support for key pricing provisions. Co-financing arrangements provide another opportunity for furthering cooperation, and include joint A.I.D.-Asian Development Bank financing of a 450 MW combined cycle power plant at Guddu. The World Bank and Asian Development Bank have also been closely involved in feasibility studies for the proposed power plant at Lakhra and are expected to assist in financing the project.

3. Project Activities: The energy portfolio is designed to maximize policy and institutional reform objectives in sub-sectors where the Mission is active. Institutional reform is explicit in many activities, including the establishment of ENERPLAN and ENERCON under the EP&D project and support for managerial and operational improvements at WAPDA under the RE project. On a smaller scale, project funds are used to demonstrate on a pilot basis the effectiveness of some of the policy approaches which the Mission supports. For example, following a request by the OGDC, the Mission procured the services of a private consulting firm to lay the groundwork for commercial participation in the development of the Dhodak oil and gas fields on a risk-sharing basis.

The \$100 ECE program, in addition to providing needed balance of payments support, is viewed as one of the best vehicles for furthering policy dialogue goals. In particular, establishment of a private sector "window" under the program gives commercial firms an opportunity to import needed energy-related equipment. As the energy portfolio expands during the post 1987 period, project activities will continue to support policy-related objectives in such areas as conservation, institutional reform, and private sector participation.

4. CPs and Covenants: Conditionality through the use of CPs and covenants provides a final tool that is used to further policy dialogue goals. Though useful for underscoring Mission concerns in specific areas and ensuring movement on discrete policy issues, it must be used with sensitivity. Several CPs under the 1982-1987 program have been included simply to ensure timely project implementation activities through the establishment of needed committees, the appointment of necessary staff, the provision of adequate funding, and, in the case of the ECE program, to set terms for private sector participation. In addition, a number of the special studies under the Rural Electrification project are specifically mandated through CPs. Use of CPs and covenants during the post 1987 period will be decided on a project-by-project basis, but will be used when appropriate.

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