



Board of Executive Directors

For consideration

On or after 14 December 2015

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Simultaneous Disclosure

To: The Executive Directors
From: The Secretary
Subject: Honduras. Proposal for a loan for the project "Programmatic Support for Structural Reforms in the Electricity Sector"

Basic Information: Loan type Programmatic Policy-Based Loan (PBP)
Borrower Republic of Honduras
Amount up to US\$24,000,000
Source Single Currency Facility of the Ordinary Capital
Amount up to US\$16,000,000
Source Fund for Special Operations

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Remarks: This operation is the second loan in a programmatic series of three consecutive single-tranche operations, technically related to one another but independently financed as programmatic policy based loans, in accordance with document CS-3633-1, "Policy-based Loans: Guidelines for Preparation and Implementation. New version".

As established in document GN-1838-1, "Criteria and norms for Board and Management relations", dated 1 July 1994, policy-lending operations are considered by the Board of Executive Directors by Standard Procedure.

The financing for this operation corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank.

Reference: GN-1838-1(7/94), DR-398-17(1/15), CS-3633-1(6/14), AB-2504(11/06), AG-9/06, CS-4100(11/15), PR-4256(12/14), DE-199/14, DE-200/14

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

**PROGRAMMATIC SUPPORT FOR STRUCTURAL REFORMS
IN THE ELECTRICITY SECTOR**

SECOND LOAN

(HO-L1118)

LOAN PROPOSAL

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This document is being released to the public and distributed to the Bank's Board of Executive Directors simultaneously. This document has not been approved by the Board. Should the Board approve the document with amendments, a revised version will be made available to the public, thus superseding and replacing the original version.

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5. Electricity Sector Financial Risk Assessment. Consulting report. Andrea Wüllner Garcés
6. Government of Honduras Strategic Plan
7. Analysis of the contribution to competitive regional integration
8. Comparative matrix of the policy conditions evaluation

(*) The borrowing country objected to the simultaneous disclosure of the document contained in this electronic link. Accordingly, it will be made available to the public once the Board of Executive Directors approves this loan proposal.

ABBREVIATIONS

CNE	Comisión Nacional de Energía [National Energy Commission]
CREE	Comisión Reguladora de Energía Eléctrica [Electric Power Regulatory Commission]
ECLAC	Economic Commission for Latin America and the Caribbean
ENEE	Empresa Nacional de Energía Eléctrica [National Electric Power Company]
FOMPIER	Fortalecimiento del Marco de Política Regulatorio e Institucional para las Energías Renovables [Strengthening the Renewable Energy Regulatory Policy and Institutional Framework]
GDP	Gross domestic product
IRR	Internal rate of return
LGIE	Electric Power Industry Act
MER	Mercado Eléctrico Regional [Regional Electricity Market]
MiAmbiente	Secretaría de Energía, Recursos Naturales, Ambiente y Minas [Ministry of Energy, Natural Resources, the Environment, and Mines]
NCRE	Nonconventional Renewable Energy
NPV	Net present value
PBP	Policy-based programmatic loan
PROMEf	Power Sector Efficiency Enhancement Project
SEFIN	Ministry of Finance
SIEPAC	Sistema de Interconexión Eléctrica para América Central [Central American Electric Interconnection System]

PROJECT SUMMARY

HONDURAS

PROGRAMMATIC SUPPORT FOR STRUCTURAL REFORMS IN THE ELECTRICITY SECTOR SECOND LOAN (HO-L1118)

Financial Terms and Conditions					
Borrower: Republic of Honduras				OC	FSO
			Amortization period:	30 years	40 years
Executing agency: Ministry of Finance (SEFIN)			Disbursement period:	12 months	12 months
			Grace period:	5.5 years	40 years
Source	Amount (US\$)	%	Inspection and supervision fee:	(a)	N/A
IDB - Ordinary Capital (OC):	24,000,000	60	Interest rate:	SCF-Fixed ^(b)	0.25%
IDB (FSO):	16,000,000	40	Credit fee:	(a)	N/A
Total:	40,000,000	100	Approval currency:	United States dollars	
Project at a glance					
Project Objectives/Description: The general objective of the programmatic series and this second operation is to support the Government of Honduras in implementing the sector reforms and policies needed to enhance financial sustainability, operational efficiency, and security of supply in the electricity sector. The specific objectives are to: (i) strengthen the sector's institutional capacity and regulatory framework; (ii) enhance financial sustainability and operational efficiency; and (iii) adopt energy policies aimed at ensuring a secure supply of electricity.					
Special contractual conditions: The sole disbursement of the Bank loan proceeds will be contingent upon fulfillment of the policy reform measures in accordance with the Policy Matrix (Annex II) and policy letter . (Paragraph 3.2).					
Exceptions to Bank policies: None.					
Project qualifies as^(c): SV [X] PE [] CC [X] CI [X]					

(a) The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

(b) The borrower will pay interest on outstanding balances on this portion of the Ordinary Capital loan at a LIBOR-based rate. The rate on the outstanding balance will be set whenever such balance reaches 25% of the approved net amount or US\$3 million, whichever is higher.

(c) SV (small and vulnerable countries), PE (poverty reduction and equity enhancement), CC (climate change, sustainable energy, and environmental sustainability), CI (cooperation and regional integration).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem, and rationale

- 1.1 **Macroeconomic conditions and fiscal policy.** Honduras ended 2014 with real growth in gross domestic product (GDP) of 3.1%, compared with 2.8% in 2013. This expansion was supported by strong growth in the financial sector (8.3%), communications (5.2%), and agriculture (2.7%), which together accounted for close to 45% of total gross value-added. In the first half of 2015 the economy grew by 3.6% year-on-year, which was faster than the 2.7% rate registered in the same period the previous year. Over the short and medium terms, real GDP growth of 3.0% to 3.5% is forecast, thanks to a more favorable external environment.
- 1.2 In 2014 the consolidated public sector deficit came to 4.0% of GDP, compared with 7.2% of GDP in 2013. In 2014 and 2015 the authorities continued the reforms to boost fiscal revenue and reduce public spending. In July 2015 Honduras's central government posted a deficit of 0.4% of GDP, smaller than the deficit of 1.2% of GDP in 2014. Consequently, public debt growth has slowed, situating total gross debt below 48% of GDP, which is equivalent to the value registered at year-end 2014. The fiscal position is expected to strengthen in the short and medium terms as established in the program with the International Monetary Fund (IMF).¹ The program establishes an increase in tax revenues to 17.1% of GDP in 2017, and a gradual reduction in current expenditure, stabilizing at 17% of GDP. On the expenditure side, a reduction in the wage bill and capital expenditure equivalent to 2.1 points of GDP is anticipated. These measures will enable the consolidated public sector deficit to be reduced by 2.5 points of GDP, bringing it down to 1.5% of GDP in three years.
- 1.3 Inflation in 2014 was 5.8%, which is inside the range set by the Central Bank of Honduras (5.5% to 7.5%). In late 2014 lower prices for oil and other mass consumer goods (beans and grains) were having a positive effect, offsetting the increase in sales tax. Annual inflation of 4% to 5% is projected over the next few years.
- 1.4 **The electricity sector.** The Honduran electricity sector is characterized by its high dependence on imported fossil fuels. In 2014 Honduras's installed electricity generating capacity was 1,834 MW, with energy supply of 8,113 GWh, of which 57% was supplied from thermal power, 23% from State-owned hydroelectric power, 16% from nonconventional renewable energy (NCRE) sources, and 4% from the Central American Regional Electricity Market (MER).² Honduras is the

¹ The reforms that facilitated the adoption of a three-year stand-by arrangement (SBA) with the IMF include: (i) increase in the sales tax (from 12% to 15%); (ii) a 25% increase in gasoline and diesel taxes; (iii) minimum payment of income tax for individuals and companies with income of over US\$500,000 per year; (iv) reduction in transfers to decentralized entities; and (v) reduction in the electricity subsidy (reduction in the subsidy threshold from 150 kWh/month to 75 kWh/month). In September 2015 the Executive Board of the IMF approved the first review of the SBA (targets at December 2014). The review of the targets indicates that the targets set for June 2015 have been met.

² As a signatory of the Framework Agreement for the Central American Electricity Market, together with the other countries of the region, Honduras participated in the development of the Central American Electric Interconnection System (SIEPAC) project, which created physical transmission infrastructure as well as an institutional and regulatory framework for participation in the MER.

second largest importer in the MER.³ Between June 2013 and June 2015, Honduras's cumulative power purchases in the MER grew by 126%.

- 1.5 The high level of hydrocarbon imports has a negative impact on the country's economy, costing US\$1.97 billion in 2014, equivalent to 10.2% of GDP. This was slightly down from the 12.5% of GDP level in 2013. Over the last five years energy demand has grown at an average of 4.5% per year and power at 48 MW/year. This reflects progress on increasing electricity supply coverage, in line with the government's targets: coverage rose from 45% in 1995 to 91.7% at the end of 2014. Installed NCRE capacity grew by 58% in 2014 compared to 2013, with hydroelectricity, biomass, and wind power projects coming on line. In 2015, 389 MW of solar-photovoltaic generation was installed, as a result of solar energy incentives.⁴ Biomass and hydroelectricity facilities were also installed. Currently, 615 MW of NCRE capacity is under construction and is due to come on line within the next five years. Projects for 437 MW are currently in the financing identification phase that have power purchasing agreements in place and are expected to be developed in due course.⁵
- 1.6 For over a decade, the Honduran electricity sector has been characterized by serious institutional weakness that limit its ability to adequately formulate, plan, and oversee energy policy and to regulate, supervise, and operate the sector effectively. This has influenced the sector's operational and financial performance and given rise to financial unsustainability to an extent that affects the quality of service, resulting in high costs for the country in fiscal, development, and competitiveness terms. In 2013 the government made the decision to launch a process of reform in the sector and adopt the measures necessary to ensure its financial sustainability, operational efficiency, and security of supply, which have been gradually consolidated under the current administration.
- 1.7 The National Electric Power Company (ENEE), the main actor in the electricity sector, is a national State-owned company that owns almost all the country's transmission and distribution systems and 29% of its installed generating capacity. The ENEE is the market's sole power purchaser, and is responsible for operating the National Interconnected System (SIN) and participating in the MER. The ENEE continues to face a high level of total energy losses from the system, which is an obstacle on the company's path to financial sustainability. Most of the losses are nontechnical, i.e., caused by weaknesses in the commercial area. Although the expected level of 32% was achieved in 2014, this indicator is not expected to reach the target of 29% in 2015, mainly as a result of delays in concluding the process of selecting the operator for the distribution segment.

³ These data correspond to cumulative imports over the period from January 2013 to June 2015, the value of which is calculated at 512 GWh for Honduras.

⁴ As at July 2015, 389 MW of capacity had been installed through the "premium incentive" established in the reform to the Electricity Generation Incentives Law, using NCRE, which granted a premium of US\$0.03/kWh to the first 300 MW installed before July 2015.

⁵ *Estudio de Mercado de Proyectos de Energías Renovables Conectados a la Red* [Market study on grid-connected renewable energy projects]. *Enclude*. December 2013.

- 1.8 **Progress on the reform process.** The government has made significant progress on the proposed reform process, which led to the entry into force of the sector regulatory framework, with the Electric Power Industry Act (LGIE) on 4 July 2014. This legislation is aimed at correcting the sector's institutional, regulatory, and operational weaknesses and boosting its fiscal impact. The reforms introduced by the LGIE include: (i) creation of the Electric Power Regulatory Commission (CREE); (ii) establishment of a National Electricity System Operator responsible for ensuring continuous and secure electricity supply and system operation; (iii) private sector participation in the distribution, transmission, and system operation segments; (iv) modernization and restructuring of the ENEE as a holding company with generation, distribution, transmission, and system operation subsidiaries; (v) free access to the electricity grids and setting of charges for their use; and (vi) creation of the *Fondo Social de Desarrollo Eléctrico* [Social Fund for Electric Power Development] to finance social interest projects.
- 1.9 The implementation of a series of measures has succeeded in reducing the impact of the ENEE's financial situation on the consolidated public sector deficit, which went from 1.8% of GDP at year-end 2013 to 1.3% in December 2014 and an estimated 0.4% of GDP at year-end 2015. The operating income versus current expenditure indicator is expected to rise from 0.82 in 2013 to 1.05 in December 2015 (from 0.86 in December 2014). Both these indicators exceeded the targets set in the stand-by arrangement with the IMF. The main adjustment measures contributing to these results were: (i) correcting the bar rate adjustment formula for fuel prices (generation costs plus transmission charges);⁶ (ii) correcting the cross-subsidy in the residential sector, causing a rate adjustment in the 0 to 300 kWh/month consumption range; (iii) targeting the direct subsidy by reducing the original allocation by 60%; (iv) reducing the workforce, with a projected reduction in payroll of one billion lempiras per year; and (v) recovering the public and private sector past-due portfolio, with a projected reduction of 500 million lempiras by the end of the year. Lower international oil prices have helped achieve the first two adjustments and enabled thermal energy to offer competitive prices. These measures, in conjunction with the forthcoming contracting of the operator/manager to reduce distribution losses, will allow the ENEE to balance its books in 2018, helping the sector achieve financial sustainability as required by the IMF's stand-by arrangement.
- 1.10 **Bank support.** The Bank has worked with the government in the sector reform process since its beginnings in 2013 through technical assistance supporting the analysis and development of the components of the reform. This included, for example, revision of the rate schedule, preparation in the review of thermal power purchase contracts expiring between 2016 and 2017, introduction of natural gas, and analysis of options for the system operator. The Bank has been supporting the government with finance for transmission infrastructure, a sector

⁶ In early December 2014 rates were increased to 8.5% and in late December to 10.1%. In 2012, according to ECLAC's 2012 electricity subsector statistics, average rates in Honduras were US\$0.075/kWh for residential customers, US\$0.005/kWh for business customers, and US\$0.03/kWh for industrial customers, and are thus lower than in Costa Rica, El Salvador, Guatemala, and Nicaragua.

that lags behind significantly at the national level.⁷ In December 2014 the Bank approved the first of the series of three loans in the policy-based programmatic loan (PBP) modality, for US\$130 million—Programmatic Support for Structural Reforms in the Electricity Sector (3386/BL-HO). This operation’s strategy included the following reform actions: (i) developing the sector’s legal, regulatory, and institutional framework with a view to achieving its sustainability; (ii) enhancing the financial and operational performance of the electricity market and the ENEE to achieve the sector’s financial sustainability and operational efficiency, and consequently reduce the ENEE’s contribution to the consolidated public sector deficit; and (iii) adopting energy policies to ensure electricity supply security, aimed at improving efficiency and ensuring the country has a secure electricity supply, whether from its own generating sources or via imports from the MER. The reforms are in line with the objectives promoted in the MER framework and therefore strengthen the electrical integration initiative for the countries of Central America (SIEPAC project).

- 1.11 **Results and progress under the first loan** The impact indicators and outcomes reported in the Results Matrix for the first loan under the PBP show significant progress in 2014 and make it possible to infer that the 2015 targets will be met. Specifically: (i) the impact indicator “ENEE’s contribution to the consolidated public sector deficit/GDP (%)” outperformed the 1.5% target in 2014, dropping to 1.3%, and it is expected to reach 0.4% in 2015; (ii) the outcome indicator “Index of electricity sector losses” has remained constant at values of 32% (against a target of 29%); (iii) the outcome indicator “Generation from renewable energy sources/total electrical power generation” reached 39.2% in 2014 (against a target of 38%); and (iv) the outcome indicator “Amount of energy traded on the MER/energy available” reached 3.6% in 2014 (against a target of 3%).
- 1.12 The progress achieved in 2015 on the agenda of reforms supported by the PBP included:
- 1.13 **Electric Power Regulatory Commission (CREE).** In June 2015 the CREE was constituted with the appointment of the three commissioners defined in the LGIE. The CREE has resources from the national budget and the allocation established by the LGIE of 0.25% of the ENEE’s sales as distributor. The commissioners have been working on the process of winding up the National Energy Commission (CNE) and transferring material and financial resources to the CREE; on the preparation, approval, and entry into force of the CREE’s rules of procedure; and on the general regulations of the LGIE and complementary regulations. The CREE formulated the action plan for its first 12 months with the timetable for issuing the regulatory provisions required by the LGIE (paragraph 1.30).
- 1.14 **Lead authority of the electricity subsector.** Pursuant to the LGIE, the lead agency for the electricity subsector remains the Ministry of Energy, Natural

⁷ The ENEE’s 2011 strategic plan reports demand for transmission project investments equivalent to 2.3% of GDP. As part of the support for investments in the transmission sector, operation HO-L1106 is currently in preparation, which aims to reinforce the transmission system in the northern and western zones of the country and help transport electricity from renewable energy projects and integration with the MER.

Resources, the Environment, and Mines (MiAmbiente), through its National Energy Department, which is the body responsible for formulating the policies that will guide the activities of the electricity subsector and monitor the policies adopted. Before the launch of the reform, the de facto sector authority was the ENEE, with limited participation by MiAmbiente. As part of the reform's current process of transition, the government has set up an energy office comprising senior national government representatives to decide on sector policy. Confirmation of MiAmbiente's designation as the lead authority in the sector makes it possible to move forward with the formulation of electricity subsector policies independently from the ENEE.

- 1.15 **Modernization of the National Electric Power Company (ENEE).** The ENEE has been set up as the holding company for the new ENEE business group, and it has subsidiaries for the generation, transmission, distribution, and system operation businesses. It has also undergone a phase of restructuring, resulting in a 52% cut in its workforce. With the support of the distribution loss reduction trust, the bidding documents and conditions were drawn up and proposals solicited for the selection of the private operator, which will be responsible for reducing distribution losses. The process is in the final stage for contracting. Financially, the ENEE meets the consolidated deficit targets laid down in the Honduran government's action plan, which are consistent with the IMF stand-by agreement targets (paragraph 1.9). Progress was made on cleaning up the information to prepare business financial statements in line with independent audit standards, and on thermal producers' past-due accounts. Over the course of the year, actions have been taken to reduce public entities' past-due accounts with the ENEE.
- 1.16 **Loss reduction.** The various actions taken by the government and the ENEE to reduce commercial losses include: (i) communication campaigns; (ii) law enforcement operations to identify customers that are stealing electricity or have illegal connections; (iii) continued installation of meters, as part of the World Bank-funded Power Sector Efficiency Enhancement Project (PROMEF), so as to control the billing of large consumers, together with implementation of an integrated collection problem and commercial management system; (iv) exchange of experiences with companies in other countries in the region, in particular the loss reduction program implemented in Ecuador; and (v) preparation of the bidding documents and conditions for the contracting of the operator/manager that will undertake: (a) the metering, billing, and collection of payment for energy sold by the distribution system, as well as provide customer services; (b) operation and maintenance of the distribution system; and (c) reduction of distribution system losses. The upward trend in losses was partly frozen as a result of implementing the PROMEF, with control of large consumers. This project is in full swing and aims to reduce losses in the fourth quarter of 2015. In April 2015 an international competitive bidding process was conducted to contract the distribution manager/operator for commercial management (metering, billing, and collection), maintenance, and operation of the distribution network; and to reduce nontechnical losses. The contracting of the operator/manager that has the technical and financial capacity to achieve the level of loss reduction will contribute to improving the ENEE's financial position. The operator is due to be contracted by January 2016.

- 1.17 **Other progress in 2015.** A number of NCRE projects were added to the national electricity grid: 75 MW from wind energy (expansion of Cerro de Hula and San Marcos in the south of the country), 389 MW from solar photovoltaic power, and 35 MW from biomass. Various Bank-funded transmission projects came on line, such as the Amarateca substation (the country's largest) and the Las Flores Erandique and Danli Chichicaste transmission lines.
- 1.18 **Actions postponed.** Some of the measures and commitments planned for 2015 could not be achieved under the second loan in the series, however. These are now scheduled to be fulfilled before approval of the third loan. It is important to emphasize that the strategic measures undertaken by the government and included in this loan make it possible to move forward with the reform process in a consolidated manner. In addition, the actions carried out by the government are necessary to achieve the established objectives once the programmatic series is completed. The main actions in this group include: (i) establishment of a contract with the private operator for the ENEE's distribution and transmission segments. The process for distribution, assigning clearly defined functions, is in its final stages, with definition due early next year. The process for transmission has not yet begun. Priority has been given to contracting the distribution operator—where the bulk of losses are concentrated—so as to help the company stabilize its financial situation, after which the decision to contract the transmission operator can be made; (ii) the configuration of the system operator, the strategy for which is still being developed.⁸ Given that the private operators have not yet been contracted, the system can continue to be operated by the national dispatch center; (iii) the CREE having the necessary staff and capacity to regulate the sector. Given that the commissioners were appointed in June 2015, progress has been made on winding up the previous regulator, defining the organizational structure and the regulator's job profiles and functions, and launching the process of recruitment of professionals, by means of a transparent and competitive process, so as to enable implementation prior to the third loan; (iv) completion of at least one power purchase process by distribution companies, based on competitive procedures. It is projected that power will need to be purchased as of the second half of 2016 and in 2017 when the current power contracts expire. The ENEE is currently being supported by consultants specializing in the preparation of technical specifications and bidding documents for power purchases; and (v) the development and entry into force of the following regulations: (a) on rates, including the methodology for bidirectional metering and billing, and multiple-schedule rates. To be effective, it would take at least a year to implement the adjustment to each procedure required by the new legal framework, in order to update the composition of the energy matrix. The existing rules will apply while the baseline studies for the new regulations are being prepared; and (b) the regulations on the distribution and transmission service. The drafts of these regulations are available. Their definition depends on progress in the selection of new managers/operators for distribution and transmission services.

⁸ The legislation provides for the operator to be a not-for-profit entity.

- 1.19 **Challenges for the electricity sector.** Despite significant headway on the reform agenda, the government needs to give priority to the following actions in the short term to ensure progress and consolidation of the process:
- a. strictly comply with the action plan approved by the CREE so as to have the regulatory provisions required by the LGIE, complementary to the General Regulations under that law, no later than 12 months after the CREE is constituted;
 - b. complete the process of contracting the operator for the ENEE distribution segment, so as to immediately start loss reduction mechanisms allowing the established targets to be achieved as of 2016;
 - c. launch the process of contracting private operators/managers for the transmission segment;
 - d. prepare processes whereby distribution companies purchase power, based on competitive bidding procedures for thermal energy contracts expiring in the next few years and integration of renewable energy sources, as established in LGIE;
 - e. set up the National Electricity System Operator, which is to define and publish the generation and transmission expansion plan; establish the Market Agents Committee; and contribute to the contracting of private operators;
 - f. make the investments necessary to comply with the MER regulator's request for investments in transmission system strengthening in Honduras to intensify the use of SIEPAC; and
 - g. integrate variable NCRE sources (photovoltaic and wind) into the national and regional electricity grid, thanks to the relevant development of variable NCRE projects nationally, generated by technology development that has caused a drop in investment costs, and to the expected results from implementation of the legislation creating incentives for NCRE use.
- 1.20 **Bank support in the sector and lessons learned.** The Bank has extensive knowledge of the Honduran electricity sector and has been supporting the Honduran government with investment loans to modernize the distribution and transmission infrastructure, the national dispatch center, and integration with the MER, as well as through technical assistance in the form of sector studies aimed at targeting subsidies, identifying options for enhancing the fiscal sustainability of the sector, and improving financial and accounting control procedures at the ENEE. The Bank coordinates the G-16 international cooperation forum on infrastructure and energy.⁹ The Bank works with Honduras on these actions with support for substantive policy reforms that make it possible to fully leverage the results through a consolidated institutional framework. The PBP modality was considered the best suited to this purpose.

⁹ The G-16 brings together various aid agencies supporting Honduras and was created as a platform for coordination in the aftermath of Hurricane Mitch. It is used to set up donor coordination forums. The IDB currently chairs the G-16.

- 1.21 The Bank has extensive experience and lessons learned for structuring operations of this kind in the sector, including projects in the Dominican Republic (2610/OC-DR), Nicaragua, (3068/BL-NI), Suriname (2848/OC-SU), and Peru (2847/OC-PE). In general, and in accordance with the project completion report from operation 2847/OC-PE, programmatic operations were found to be the most suitable instruments for supporting sector reform involving multiple actors. Moreover, with the possibility of a diversified and sustainable energy supply, end consumers are the main beneficiaries of this type of intervention. The following lessons have been learned from such interventions and have been taken into account in the design of this PBP: (i) institutional and regulatory reforms are not in themselves sufficient to ensure that the sector will operate efficiently. It is essential that the institutions created are able to perform their lawfully mandated duties independently from the executive and legislative branches of government; (ii) policy measures, particularly regulatory measures, need to be implemented on a gradual basis but should from the outset be subject to a well-defined timetable and clearly assigned responsibilities; (iii) the success of loss reduction and operational efficiency enhancement programs depends on: solid political support; the availability of financial resources to execute the multiyear program without interruptions; the existence of an institutional structure in which the distribution companies that execute the loss reduction programs are accountable to managers of the holding company being created for the investments they make and for the results they obtain; and (iv) the Bank should closely support the Government of Honduras through technical assistance during the process of implementing the institutional changes and policy measures.
- 1.22 **Program strategy.** This loan continues the program of electricity sector reforms, comprising a series of three operations in one PBP, in accordance with the Bank's Policy-based Loans: Guidelines for Preparation and Implementation (document CS-3633-1). The PBP supports the implementation of structural reforms in the electricity sector, with the measures necessary to achieve the sector's financial and operational sustainability. The programmatic structure has been selected for the flexibility it provides in the attainment of long-term objectives through the implementation of sequential short- and medium-term measures, which are agreed by the government and the Bank according to the progress made and the macroeconomic and sector environment being faced at the different stages. This second loan advances the reforms aimed at the electricity sector's financial sustainability and operational efficiency, with a positive impact on public finances and long-term growth, and at the process of integrating the region's electricity systems, benefiting the population as a whole. The third loan will complete the reform process, fulfilling the program's objectives and complying with the provisions of the LGIE. It is therefore necessary for the lead authority, the CREE, the system operator, and the Market Agents Committee to be functioning effectively. The ENEE has to continue on its path towards financial sustainability, operating with an efficient rate and subsidy system, in a competitive market with flexible participation in the MER.
- 1.23 **Government strategy.** The Government of Honduras has stated its commitment to foster policies that promote the Honduran electricity sector's sustainability and efficiency as a key part of the country's economic, social, and environmental development policies. The current [Strategic Government Plan \(2014-2018\)](#),

adopted and published through the General Government Coordination Department of the Office of the President of the Republic, includes this commitment as a strategic objective with concrete results, consisting of the targets proposed in the reform process and the PBP.

Table I-1. Strategic Government Plan 2014-2018

Strategic Objective	Subsector objective	Outcome
<p>Make Honduras the country with the best productive infrastructure and logistics in Central America by carrying out transportation projects, supplemented by renewable energy, telecommunications, and irrigation projects that reduce production costs and boost the country's competitiveness.</p>	<p>Ensure quality, excellence, and responsibility in the supply of electricity, in support of the productive sectors and the population and in harmony with the environment.</p>	<p>A larger share of renewable energy in the country's energy matrix.¹⁰</p>
		<p>Energy losses reduced by half.</p>
		<p>The ENEE statement of operations shows a surplus achieved through a reduction in energy losses, recovery of past due accounts, rationalization of wages, and rebalancing of power purchase costs and electricity rates.</p>
		<p>Subsidy system for electricity rates simplified and better targeted.</p>

- 1.24 **The Bank's country strategy with Honduras.** The operation is consistent with the Bank's Country Strategy with Honduras (2015-2018) (document GN-2796-1), which places priority on the energy sector's sustainability and competitiveness, supports the process of electricity sector reform, and maintains a permanent dialogue with the sector authorities on the priority reforms implemented.
- 1.25 **Strategic alignment.** The program will contribute to the following financing priorities of the Ninth General Increase in Resources of the Inter-American Development Bank (document AB-2764) (GCI-9): (i) support development of small and vulnerable countries; (ii) support climate change initiatives, renewable energy, and environmental sustainability, by increasing the share of renewable sources in the energy mix, so as to reduce greenhouse gas emissions; and (iii) support regional cooperation and integration, through regulatory and institutional improvements that promote integration of the Honduran electricity market with the MER. The program is aligned with the priority areas of the IDB Infrastructure Strategy: Sustainable Infrastructure for Competitiveness and Inclusive Growth (Operational Policy OP-1012, document GN-2710-5), by promoting access to infrastructure services, fostering innovative arrangements for infrastructure financing, and leveraging private sector participation. In the context of the IDB Sector Strategy to Support Competitive Regional and Global Integration (document GN-2565-4) and in accordance with the guidelines for

¹⁰ The objectives of the Country Vision 2010-2038, set out in Legislative Decree 286-2009 of 2 February 2010, envisage the share of renewable energy in the matrix rising from 65% in 2017 to 80% in 2022.

operation classification and validation, the program is consistent with the GCI-9 objective of regional integration financing (documents GN-2650 and GN-2733), in accordance with the “National Subsidiarity” principle, as discussed in [optional electronic link 7](#), as the program reforms will help harmonize the rules for energy exchange between the countries of Central America and are therefore in line with the MER’s objectives. The program is aligned with the activities of the Northern Triangle Alliance for Prosperity Plan in the strategy area of stimulating the productive sector to create economic opportunities, by reducing energy costs and enhancing the reliability of the electricity service.

- 1.26 **Consistency with Bank policies.** With the second loan under the PBP, the program remains consistent with the objectives stated in the Public Utilities Policy (document GN-2716-6) and complies with the financial sustainability and economic evaluation conditions, as indicated in the analysis of compliance with this policy ([optional electronic link 3](#)). The reforms promoted by the program reflect the Honduran government’s commitment to making the necessary adjustments in the sector’s legal, institutional, and regulatory framework to establish a rate structure that reflects the real costs of generation, transmission, and marketing of electricity, and targets direct subsidies on low-consumption users.

B. Objectives, components, and cost

- 1.27 The general objective of the programmatic series and this second operation is to support the Government of Honduras in implementing the sector reforms and policies needed to enhance financial sustainability, operational efficiency, and security of supply in the electricity sector. The specific objectives are to: (i) strengthen the sector’s institutional capacity and regulatory framework; (ii) enhance financial sustainability and operational efficiency; and (iii) adopt energy policies aimed at ensuring a secure supply of electricity.
- 1.28 **Macroeconomic Stability.** As a general condition, the program requires maintenance of a stable macroeconomic framework in order to ensure macroeconomic conditions consistent with the program’s objectives, as provided in the Policy Matrix.
- 1.29 **Component 1. Implementation of a suitable legal, regulatory, and institutional framework for the electricity sector.** This component will support institutional strengthening aimed at: (i) having a legal, regulatory, and institutional framework that ensures the sustainability of the sector; (ii) implementing the new institutional structure of the lead authority in the electricity sector, with an organizational structure, the trained staff required, the necessary budget allocation, and an annual work plan; (iii) ensuring institutional capacity to regulate activities in the electricity sector; and (iv) having a regulatory framework with the regulations required for national electricity system operation and planning in line with the operational and commercial rules of the MER.
- 1.30 For this second operation under the PBP, the following commitments included in the Policy Matrix have been fulfilled: (i) the CREE has approved the general regulations of the LGIE and they are in effect; the operating regulations of the electricity system and the national electricity market are defined and approved; and the CREE has approved its action plan to ensure that it has the regulatory

- provisions required by the LGIE, no later than 12 months after the CREE is constituted. These are to include the following regulations: electricity rates and rate adjustment regulations, distribution service regulations, including quality of service, bidirectional metering, and contributions, and transmission service regulations, including the schedule of prices applicable for system use; (ii) the new institutional structure of the electricity sector's lead authority has been established and implemented and the authority appointed, and it has an organizational structure with a trained basic staff, the necessary budget allocation, and an annual work plan; and (iii) the CREE commissioners have been appointed and are exercising their functions; the material and financial resources of the National Energy Commission have been transferred to them; the CREE's rules of procedure have been approved and are in effect; and the organizational structure, job profiles and functions, and budget structure have been defined.
- 1.31 This component's trigger mechanisms for the third loan under the PBP are that: (i) the LGIE and the regulations are in effect and the CREE has finished the issuing the regulatory provisions required by the LGIE; (ii) the lead authority of the electricity sector is operating as the apex agency in the sector and the CREE as the regulatory body for the sector's activities; (iii) the National Electricity System Operator has been constituted, and is responsible for defining and publishing the generation and transmission expansion plan and supervising and overseeing operations of the National Interconnected System; and (iv) the Market Agents Committee has been established, and is periodically evaluating performance and putting forward proposals for measures to improve electricity system and market operation.
- 1.32 **Component 2. Improvement of the electricity sector's financial sustainability and operational efficiency.** This component will support an improvement in the efficiency of the sector through measures aimed at: (i) restructuring the ENEE in order to enhance the sector's operational and financial performance; (ii) promoting competition in the electricity sector and strengthening the electricity market by improving the power purchase procedures; and (iii) having a rate structure in place that allows for adequate compensation for chain participants, with competitive end-user rates and a direct subsidy targeted on low-consumption users.
- 1.33 For this second loan under the PBP, the following commitments included in the Policy Matrix have been fulfilled: (i) the ENEE has been restructured and incorporated as a holding company with subsidiaries for the generation, transmission, distribution, and system operation businesses; the ENEE has the capacity to issue financial statements complying with independent audit requirements; and the ENEE is meeting all the consolidated deficit targets established in the government action plan; and (ii) rates continue to be periodically adjusted based on the methodologies in force, while the new rate regulations are issued; direct subsidies have been reduced and cross-subsidies eliminated, as part of the process of subsidy targeting.
- 1.34 This component's trigger mechanisms for the third loan under the PBP are that: (i) the ENEE has strengthened its generation business unit and participates in the market on a competitive basis, it has established contracts with private

operators/managers for the transmission and distribution segments (which are operating satisfactorily), and it complies with consolidated deficit targets established in the government action plan; (ii) energy is bought through competitive bidding procedures based on agreed standard contracts, consistent with the approved generation expansion plan; and (iii) the rate structure regulations are developed and are in effect and rates are periodically adjusted based on the methodologies approved by the CREE; subsidies are given based on the regulations and their provisions for subsidy targeting; and the CREE approves the rates for the remuneration of each company's transmission and distribution activities.

- 1.35 **Component 3. Adoption of energy policies designed to ensure a secure supply.** This component will support an enhancement in the sector's operational efficiency and expansion through a regulatory framework that: (i) promotes the diversification of clean energy sources and a reduction of power generation costs; (ii) promotes energy efficiency; and (iii) is harmonized with the MER.
- 1.36 For this component of the second loan under the PBP, the following commitments included in the Policy Matrix have been fulfilled: (i) the LGIE's legal framework has been harmonized with the Renewable Energy Generation Incentives Law to provide incentives for the production of clean energy at competitive costs; (ii) review procedures for the approval of generation projects, including environmental requirements, have been enhanced; (iii) energy efficiency and savings plans have been prepared and approved in at least 10 public-sector institutions; and (iv) the existing regulatory framework allows power purchase bidding procedures to include the participation of generation from MER countries.
- 1.37 This component's trigger mechanisms in the third loan under the PBP are aimed at the inclusion of NCRE in the expansion plan; technology-based power purchase auctions; implementation of the methodology for bidirectional metering and billing; implementation of energy efficiency action plans and the multiple-schedule rate structure; and inclusion of power generation from MER countries in power purchase processes.¹¹

C. Key outcome indicators

- 1.38 Achievement of the program objectives is measured against the indicators and targets set forth in the Results Matrix ([required electronic link 4](#)), which reflects the comprehensive scope of the PBP, through its three individual operations as shown in the Policy Matrix (Annex II). The expected outcomes of the program are: (i) improvement in the operational and commercial efficiency of the electricity sector; (ii) increase in the share of renewable energy in the energy matrix; and (iii) increase in MER transactions.
- 1.39 As an impact of the program, the sector's enhanced financial sustainability is expected to lead to a reduction in the ENEE's contribution to the consolidated public sector deficit, allowing fiscal transfers to the ENEE to be reduced, and

¹¹ In parallel, the system's expansion plans will include the investments in the transmission system required for its participation in the MER to be viable. This is a critical point of the strategy under the Northern Triangle Alliance for Prosperity Plan.

generally benefiting the entire population of Honduras. The reforms promoted are expected to benefit the process of regional electricity system integration through: (i) more competitive renewable energy prices compared to thermal energy; and (ii) harmonization of the regulatory framework, with regulations on bidding processes for power purchases in the MER.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

- 2.1 The second loan in a sequence of three individual PBP operations is being financed (paragraph 1.22). The amount of each loan is determined by the financing needs for the development of Honduras and the country's borrowing limit with the Bank. The first operation was for US\$130 million. The second operation will be for US\$40 million (US\$24 million from the Ordinary Capital (OC) and US\$16 million from the Fund for Special Operations (FSO)). The amount was determined by the Government of Honduras based on its projected financing needs for 2015, which are estimated at 2.4% of GDP (US\$480 million), 33.3% (US\$160 million) of which is comprised of foreign debt. The PBP will cover 26.3% of the country's external financing needs. The loan is consistent with the country's stand-by arrangement with the IMF, which envisages budgetary support from the Bank as a main pillar of the electricity sector reform process.

B. Environmental and social risks

- 2.2 In accordance with Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20 and Operational Policy OP-703), an environmental impact classification is not required. The proposed reforms will not cause adverse environmental or social impacts.

C. Fiduciary risks

- 2.3 There are risk factors related to the institutional capacity of the public sector associated with financial management, which are considered medium. To mitigate them, the Bank is undertaking technical support and strengthening actions. Implementation of the Integrated Financial Management System and the General Treasury Account has resulted in more prudential and disciplined cash management, greater decentralization of the treasury function, and more reliable financial statements. To contribute to better operational and financial performance of the ENEE, the commitments to be fulfilled under the PBP include an accounting separation of the ENEE's various areas and a report providing financial statements for each of the different segments (generation, distribution, and transmission).
- 2.4 The Ministry of Finance (SEFIN) has extensive experience in the execution of reform processes and is leading the process that this PBP is supporting in the electricity sector. Since several agencies will be involved in executing the planned reforms, there is a risk of lack of coordination among them. To mitigate this risk, the Bank will continue to hold monitoring meetings at least every three months to monitor developments and outcomes and identify the additional support required to meet the conditions and comply with the program's monitoring and evaluation plan (paragraph 3.3). The Bank will continue to support the government in the strengthening of the institutional capacity of the

sector's agents through technical cooperation with Honduras: Institutional Strengthening for Energy Sector Actors (ATN/KR-14667-HO), which aims to provide technical support for the authorities on reform implementation.

D. Sustainability and other project risks

2.5 **Economic and financial viability.** An [economic and financial evaluation](#) of the impact of the program's proposed reforms was performed, considering measures such as energy loss reduction, subsidy targeting, and diversification of the generation matrix by introducing renewable sources, which are induced by the reforms being supported. The economic and financial costs and benefits associated with each of these measures when calculating the net annual flows were discounted at a rate of 12%.

2.6 As the program's objective is to improve the electricity sector's financial sustainability, operational efficiency, and security of supply, the benefits are mainly associated with the financial viability of the measures. The expected benefits of these measures are associated with: (i) generation avoided by reducing losses, given the expected reduction in consumption by users facing rising prices for service they were not previously charged for; (ii) generation avoided due to reduced consumption by users who have the capacity to pay and will now receive a smaller subsidy and will consequently be charged higher rates; (iii) increased financial income for the ENEE due to reduced losses and subsidies; and (iv) increased share of renewable energy in energy production, resulting in lower generating costs because of less generation from thermal energy.

a. In the case of loss reduction, the measures require a significant investment, translating primarily into financial benefits for the electricity company, through increased revenue in the form of charges for the recovered energy. The analysis takes on importance from the ENEE's financial viewpoint, with a focus on recouping the capital from the planned investments. The results of the evaluation show that the company's financial sustainability is not at risk. Users will continue to have access to the electricity service, although they may adjust their consumption in response to the price increases. The economic and financial net present values (NPV) are positive, with the economic internal rate of return (IRR) lower than the financial IRR. The latter will increase over time, because the benefits will be achieved over a longer period. The financial IRR is 74%. The sensitivity analysis shows the robustness of the financial results in the event of a change in the structure of demand, despite the greater rigidity of consumption levels vis-à-vis price changes; and a strengthening of results in response to increases in rates.

b. By targeting subsidies, the rate increase will have an impact on users whose subsidy is reduced. This measure entails minimal implementation costs. The measure produces economic benefits from electricity generation avoided as a result of reduced consumption in response to higher rates. It generates financial benefits by increasing the company's total income, as a result of higher rates for all users. The drop in total consumption is insufficient to cancel out the resulting rate differential. The financial and economic NPVs are positive (US\$111.9 million and \$748.6 million, respectively) and in both cases the IRR exceeds the discount rate applied.

- c. The economic value of renewable energy sources is in their potential to compete with the ENEE's marginal costs, which are currently represented by the cost of buying thermal energy. The cost of thermal energy avoided resulting from renewable energy sources being added to the system is calculated based on the cost of investing in renewable energy in the plans of the ENEE and the private sector. An economic IRR of 33% and a positive NPV are achieved. The sensitivity analysis looked at the effect of reductions in the cost of buying thermal energy and a lower discount rate. The project continued to show positive results with all the possible combinations.
 - d. Taking into account the investments in generation projects and loss reduction programs induced by the proposed reforms, the analysis yields an aggregate economic IRR of 32% and an NPV of US\$2.374 billion. The evaluation includes a sensitivity analysis for critical variables such as price elasticity of demand, charges, cost of electricity, and discount rate. This analysis showed the results to be robust in the base cases considered.
- 2.7 There are additional unquantified benefits, such as Honduras being better able to participate in the Regional Electricity Market (MER). Since Honduras is a net electricity importer, better access to power at more competitive prices and new generating capacity investments that could be avoided represent important benefits from the economic and financial standpoint.
- 2.8 **Sustainability and financial analysis of the ENEE.** The program supports policy measures that ensure long-term sustainability of the benefits by establishing a solid legal, regulatory, and institutional framework, enhancing financial sustainability and sector efficiency, and ensuring the supply of energy. A financial analysis was performed of the electricity sector ([optional electronic link 5](#)), including an evaluation of the financial risks facing the sector and the identification of potential mitigation measures, considering the sector's financial sustainability and, in particular, the current situation of the ENEE. The most influential factors identified in this analysis and on which the actions of this program focus to achieve financial recovery are: the high level of energy losses, continuous application of rate adjustments, targeting of subsidies, and high generation costs associated with the composition of the energy matrix. The reforms supported by the program are aligned with the measures required to enhance the financial sustainability of the ENEE and of the sector in general. The debt stemming from this loan is consistent with the debt sustainability analysis performed by the Bank, which showed a moderate risk of unsustainability over the medium term.
- 2.9 **Other risks.** Possible delays in compliance with the trigger mechanisms for the third loan have been identified as a high preparation risk. As a mitigation measure for this risk, monitoring meetings will be held with senior authorities from SEFIN, CREE, MiAmbiente, and ENEE, with a view to monitoring compliance with the trigger mechanisms. The possibility of resistance by certain interest groups that consider themselves impacted by the reform measures, including industrial users that may perceive an increase in the cost of service, is a medium risk in terms of public management and governance. This risk will be mitigated by the government's communications to inform the various groups about the need for the proposed measures in order to ensure the sector's

sustainability. Lastly, the possibility that the independent investment projects associated with the project's expected outcomes may not be carried out has been identified as a medium implementation risk. To mitigate this risk, monitoring meetings between the Bank, SEFIN, ENEE, MiAmbiente, and CREE will be held to analyze the status of the outcomes of the independent projects and identify possible actions to avoid delays or nonfulfillment. Similarly, in coordination with the various energy sector coordination agencies, forums such as the G-16 international cooperation forum will continue to be used.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 The borrower will be the Republic of Honduras and the executing agency will be the Ministry of Finance (SEFIN). In coordination with the ENEE, MiAmbiente, the CREE, and other entities, through the Macroeconomic Policies Bureau and by holding periodic analysis and monitoring meetings, SEFIN will oversee compliance with the programmatic commitments and consolidation of sector reform. As the program's executing agency, SEFIN has the following responsibilities: (i) promote achievement of the policy objectives; (ii) provide evidence of compliance with the agreed-upon policy conditions; and (iii) compile and deliver information enabling the Government of Honduras and the Bank to measure and assess the program's outcomes.
- 3.2 The transfer of this operation's proceeds constitutes direct budget support. The funds will be transferred to the National Treasury following the financial administration procedures set forth in national legislation. The program calls for a sole disbursement once the loan contract has been signed and compliance with the special and general conditions precedent to the disbursement has been verified. **The sole disbursement of the loan proceeds will be contingent upon fulfillment of the policy reform measures set out in the Policy Matrix (Annex II) and the Policy Letter.** Such compliance will be confirmed using the tools described in the [Means of Verification Matrix](#). The Bank may request an external audit of the program if deemed appropriate.

B. Summary of arrangements for monitoring results

- 3.3 A detailed monitoring and evaluation plan has been prepared, including medium- and long-term outcome and impact indicators consistent with the policy reform process described in the Policy Matrix (Annex II). The indicators are reflected in the [Results Matrix](#). The monitoring and evaluation plan calls for monitoring and coordination meetings among the government agencies involved in executing the policy reforms, including some recently created agencies, to determine the progress made on, and status of, the reforms. The Government of Honduras and the Bank have agreed to hold periodic meetings to monitor and evaluate the Results Matrix. Before processing the third loan under the PBP, the Bank will produce a progress report reviewing the program's status and the advances made on the reforms and trigger mechanisms, and will identify any modifications and adjustments that may be required in order to achieve the program targets.
- 3.4 An ex post evaluation of the program outcomes will be carried out once the third operation is executed. The implementation methodology will be similar to that of

the ex ante economic evaluation (cost-benefit analysis) undertaken at the start of each loan in the series. A project completion report (PCR) will be prepared by the project team, no more than six months after the last operation has been disbursed. The PCR will evaluate the impacts obtained, using the cost-benefit analysis as input.

IV. POLICY LETTER

- 4.1 The Government of Honduras has agreed with the Bank on the macroeconomic and electricity sector policies being supported through the program, as set forth in the [Policy Letter](#) presented to the Bank by SEFIN, where reference is made to the main components of the PBP strategy and the Honduran government's commitment to these agreements.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives		Aligned	
Lending Program		-Lending to small and vulnerable countries -Lending to support climate change initiatives, renewable energy and environmental sustainability -Lending to support regional cooperation and integration	
Regional Development Goals			
Bank Output Contribution (as defined in Results Framework of IDB-9)			
2. Country Strategy Development Objectives		Aligned	
Country Strategy Results Matrix	GN-2796-1	To improve the efficiency and quality of electricity service and diversify the power generation matrix.	
Country Program Results Matrix		The intervention is not included in the 2015 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability		Evaluable	Weight
		8.8	10
3. Evidence-based Assessment & Solution		10.0	33.33%
3.1 Program Diagnosis		3.0	
3.2 Proposed Interventions or Solutions		4.0	
3.3 Results Matrix Quality		3.0	
4. Ex ante Economic Analysis		10.0	33.33%
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0	
4.2 Identified and Quantified Benefits		1.5	
4.3 Identified and Quantified Costs		1.5	
4.4 Reasonable Assumptions		1.5	
4.5 Sensitivity Analysis		1.5	
5. Monitoring and Evaluation		6.5	33.33%
5.1 Monitoring Mechanisms		1.5	
5.2 Evaluation Plan		5.0	
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood		Medium	
Identified risks have been rated for magnitude and likelihood		Yes	
Mitigation measures have been identified for major risks		Yes	
Mitigation measures have indicators for tracking their implementation		Yes	
Environmental & social risk classification		B.13	
IV. IDB's Role - Additionality			
The project relies on the use of country systems			
Fiduciary (VPC/FMP Criteria)			
Non-Fiduciary			
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	Yes	The Bank provides support for the institutional strengthening of agencies in the sector through technical cooperation HO-T1184.	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

61 per cent of Honduras's energy matrix depends on the supply of thermal generation and the Regional Electricity Market (MER). Honduras is the second largest importer of energy in the MER. This second tranche of the programmatic loan is framed in the context of: i) the import of large quantities of hydrocarbons to the country, which are destined in part to the generation of electricity, and account for 10.2 % of the GDP; ii) institutional weaknesses that have an impact on the operational and financial performance of the sector, and affect the quality of service; and iii) the continued growth of energy demand at an annual rate of 4.5 %. The project aims to strengthen the institutional capacity and the regulatory framework to improve the financial and operational sustainability of the sector, ensuring adequate electricity supply.

The vertical logic is solid and the results matrix presents in detail all impacts, outcomes and outputs. The reported indicators are SMART, have baseline values, concrete goals, and means of verification. The program presents a cost-benefit analysis on the main expected results, detailing all the assumptions adopted for the calculation of costs, benefits and the sensitivity analysis. The analysis establishes three scenarios: i) reduction of commercial losses of the National Electricity Company (ENEE), which proposes an analysis from the perspective of capital recovery for its major investments in order to assess the financial sustainability of the company; ii) targeting subsidies, which analyzes tariff adjustments for an improved focus of supports in consumer groups with less ability to pay; and iii) installation of renewable energies, which are intended to diversify the energy matrix, displacing the purchase of energy from thermal generation plants. All three scenarios show robust and consistent results, according to each approach.

The monitoring plan follows the output indicators derived from the policy matrix. Given the nature of the PBL, there is not a detailed relation of costs for each output. The evaluation plan proposes a before-and-after analysis and an ex post cost-benefit analysis for the three scenarios outlined in the ex ante assessment.

The delay in meeting the triggers agreed upon has been identified as a high risk, which would have a great impact on the program and has a medium probability of occurrence. This high risk, as well as all medium risks identified, present mitigation measures.

POLICY MATRIX

Objective: The general objective of the programmatic series and the second operation is to support the Government of Honduras in implementing the sector reforms and policies needed to enhance financial sustainability, operational efficiency, and security of supply in the electricity sector. The specific objectives are to: (i) strengthen the sector's institutional capacity and regulatory framework; (ii) enhance financial sustainability and operational efficiency; and (iii) adopt energy policies aimed at ensuring a secure supply of electricity.

Objectives	Commitments Programmatic I 2014	Commitments Programmatic II 2015	Indicative Reforms Programmatic III 2017
General macroeconomic policy framework			
Stable general macroeconomic policy framework	Macroeconomic environment that is stable and conducive to achieving the program objectives and the guidelines provided in the sector policy letter.	Macroeconomic environment that is stable and conducive to achieving the program objectives and the guidelines provided in the sector policy letter.	Macroeconomic environment that is stable and conducive to achieving the program objectives and the guidelines provided in the sector policy letter.
I. Implement a suitable legal, regulatory, and institutional framework for the electricity sector			
I-1 Have a legal, regulatory, and institutional framework that ensures the sustainability of the electricity sector.	<p>The General Electric Power Industry Act (LGIE), which establishes the new legal, regulatory, and institutional framework for the sector, is approved and enters into force.</p> <p>A Steering Committee is created to strategically coordinate implementation of the objectives and provisions set forth in the new LGIE. This committee will have a technical unit that will act as Executive Secretariat.</p> <p>Draft general implementing regulations of the LGIE are prepared.</p>	<p>The following regulations are approved and are in effect:</p> <ul style="list-style-type: none"> • General implementing regulations of the LGIE. • Regulations on system operations and administration of the wholesale electricity market. <p>Regulation on the purchase of firm capacity and power.</p> <p>The CREE approves the Action Plan to ensure that within not more than 12 months of its constitution it has the regulatory provisions required by the LGIE, including at least:</p> <ul style="list-style-type: none"> • Rate regulations and rate adjustment. • Regulations on the distribution service, including service quality, bidirectional metering, and contributions. • Regulations on the transmission service, including the price structure applicable for network use. 	<p>The CREE has completed issuing the regulatory provisions required by the LGIE, as established in the Action Plan, and the LGIE and implementing regulations are in effect.</p> <p>The Steering Committee submits a completion report regarding the reform implementation process, including an independent assessment of the functioning of the sector and its institutions under the LGIE and any additional measures to be adopted, as needed.</p>

Objectives	Commitments Programmatic I 2014	Commitments Programmatic II 2015	Indicative Reforms Programmatic III 2017
<p>I-2 Have the institutional capacity and trained staff needed to ensure that public policies for the electricity sector are formulated and implemented.</p>	<p>The electricity sector's lead authority responsible for setting sector policies is designated.</p>	<p>The new institutional structure of the Ministry of Energy, Natural Resources, the Environment, and Mines, as the electricity sector's lead authority, has been established and is operational such that it has:</p> <ul style="list-style-type: none"> • an organizational structure with a basic trained staff; • the required budget allocation; and • an annual work plan. 	<p>The lead authority of the electricity sector operates as the sector's apex agency, ensuring that the public policies that guide sector activities are formulated, implemented, and monitored.</p>
<p>I-3 Have the institutional capacity and trained staff needed to regulate electricity sector activities.</p>	<p>Progress is made in establishing the Electric Power Regulatory Commission (CREE), in the form of:</p> <ul style="list-style-type: none"> • Regulations for the Nominating Board. • Appointment of all Nominating Board members. • Selection of a shortlist of candidates for commissioner by the Nominating Board. 	<p>The CREE commissioners have been named.</p> <p>The CREE has been established and the National Energy Commission has transferred material and financial resources to it.</p> <p>The CREE's Rules of Procedure have been approved and are in effect.</p> <p>The CREE has defined its organizational structure, job profiles and functions, and its budgetary structure.</p> <p>The CREE has prepared and approved the operating regulations for the electricity system and the national electricity market.</p>	<p>The CREE operates as the entity responsible for regulating activities in the electricity sector.</p> <p>The CREE has the necessary staff and capacity to regulate the sector.</p> <p>The decisions made by the CREE are published as provided in the LGIE.</p> <p>The CREE submits an annual report to the Executive Branch and to Congress, indicating the functioning of the sector and any additional measures that will need to be adopted.</p>

Objectives	Commitments Programmatic I 2014	Commitments Programmatic II 2015	Indicative Reforms Programmatic III 2017
<p>I-4 Have the entity and the regulations required for national electricity system operation and planning.</p>	<p>As part of the LGIE, parameters have been defined for the creation of an independent national electricity system operator responsible for ensuring that the supply of electricity is continuous and secure and that the system is properly operated.</p>		<p>The national electricity system operator has been established, in accordance with the provisions of the LGIE.</p> <p>The Market Agents Committee has been established.</p> <p>The system operator defines and publishes the generation and transmission expansion plan.</p> <p>The system operator supervises and controls operations in the National Interconnected System, manages the opportunity market, calculates marginal cost based on minimum-cost dispatch, verifies variable costs for power producers, and performs all other duties provided in the LGIE.</p> <p>The Market Agents Committee conducts periodic performance evaluations and proposes measures aimed at improving the functioning of the electricity system and the market.</p>
<p>II. Improve the financial sustainability and operational efficiency of the electricity sector</p>			
<p>II-1 Restructure the ENEE to enhance the operational and financial performance of the sector.</p>	<p>The implementation of an action plan for the financial recovery and restructuring of the ENEE is approved.</p> <p>Control targets are set with a view to limiting the ENEE's contribution to the consolidated deficit.</p> <p>An accounting separation of the various areas of the ENEE is completed and a report containing financial statements for each of the generation, transmission, and distribution segments is produced.</p> <p>Progress is made in implementing the planned actions to restructure the distribution area of the ENEE and implement the comprehensive loss management system based on the PROMEF project's recommendations.</p>	<p>The ENEE has been restructured and is organized as a holding company for subsidiaries in the generation, transmission, distribution, and system operation business segments.</p> <p>The ENEE meets the consolidated deficit targets provided in the government's action plan.</p> <p>The ENEE has the capacity to prepare financial statements in accordance with independent audit requirements.</p>	<p>The ENEE's generation business unit has been strengthened and is competitive in the market.</p> <p>Contracts have been established with private operators/managers for the ENEE's transmission and distribution segments and they operate satisfactorily.</p> <p>The ENEE meets the consolidated deficit targets established in the government's action plan.</p>

Objectives	Commitments Programmatic I 2014	Commitments Programmatic II 2015	Indicative Reforms Programmatic III 2017
II-2 Promote competition in the electricity sector and strengthen the electricity market by improving the power purchase procedures.	<p>The price and supply terms of the power purchase agreements entered into with private thermal producers whose agreements expire in 2014 are reviewed.</p> <p>Progress is made toward carrying out competitive energy purchase procedures by preparing draft standard thermal power purchase contracts.</p>		<p>Power purchases are carried out by means of competitive bidding processes based on agreed-upon standard contracts consistent with the approved plan for expanded power generation.</p>
II-3 Have a rate structure in place that allows for adequate compensation of chain participants, with competitive end-user rates and a direct subsidy targeted to low-consumption users.	<p>As part of the electricity sector reforms, a transparent and sector-appropriate rate, fiscal, and tax structure is formulated.</p> <p>The fuel-based rate adjustment formula is reviewed and updated.</p> <p>The institutional responsibilities and procedure for implementation of the subsidy targeting of electricity consumers are determined beginning in 2015.</p>	<p>Rates continue to be periodically adjusted based on the methodologies in force, while the CREE issues new methodologies.</p> <p>Direct subsidies are reduced and cross-subsidies eliminated, as part of the process of subsidy targeting.</p>	<p>The rate regulations are formulated and enter into force.</p> <p>The CREE approves the charges for compensating the transmission and distribution activities of each company.</p> <p>Rates are adjusted periodically based on the methodologies approved by the CREE.</p> <p>Subsidies are delivered based on the subsidy targeting regulations and associated provisions.</p>
III. Adopt energy policies designed to ensure a secure supply			
III-1 Have a regulatory framework that promotes diversification into clean energy sources and a reduction of power generation costs.	<p>As part of the electricity sector reforms, it is determined that all renewable energy purchases will be carried out by means of competitive bidding processes.</p> <p>Execution of the Project to Strengthen the Renewable Energy Policy and Institutional Framework (FOMPIER), with a view to proposing the methodologies required for the competitive processes, is initiated by hiring the coordinator for the project.</p>	<p>The legal framework of the LGIE has been harmonized with the Renewable Energy Generation Incentives Law to provide incentives for the production of clean energy at competitive costs.</p> <p>Review procedures for approving generation projects, including environmental requirements, have been improved.</p>	<p>A mapping of nonconventional renewable energy resources is included in the expansion plan.</p> <p>Technology-based power purchase auctions are conducted.</p> <p>The methodology for bidirectional metering and billing has been implemented.</p>

Objectives	Commitments Programmatic I 2014	Commitments Programmatic II 2015	Indicative Reforms Programmatic III 2017
<p>III-2 Have a regulatory framework and policies that promote energy efficiency.</p>	<p>Instructions are issued to prepare energy efficiency and savings plans at public-sector institutions.</p> <p>Instructions are issued to create a rate structure that incentivizes consumption during off-peak hours and provides for increases during peak hours (multihour rates).</p>	<p>Energy efficiency and savings plans have been prepared and approved in at least 10 public-sector institutions.</p>	<p>The energy efficiency and savings plans are satisfactorily executed at public-sector institutions and a report is presented showing the results of the savings obtained.</p> <p>A rate structure that incentivizes consumption during off-peak hours and provides for increases during peak hours (multihour rates for commercial and industrial users) has been implemented and is in effect.</p>
<p>III-3 Have a regulatory framework harmonized with the Regional Electricity Market (MER).</p>	<p>The interfaces between the Honduran electricity market and the MER are in effect.</p>	<p>The existing regulatory framework allows bidding processes for power purchases to include power generation from MER countries.</p>	<p>The bidding processes for power purchases allow the inclusion of power generation from MER countries.</p>

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/15

Honduras. Loan ____/BL-HO to the Republic of Honduras
Programmatic Support for Structural Reforms
in the Electricity Sector – Second Loan

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a Programmatic Support for Structural Reforms in the Electricity Sector – Second Loan. Such financing will be for the amount of up to US\$24,000,000 from the resources of the Single Currency Facility of the Bank's Ordinary Capital, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ _____ 2015)

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That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a Programmatic Support for Structural Reforms in the Electricity Sector – Second Loan. Such financing will be for the amount of up to US\$16,000,000 from the resources of the Bank's Fund for Special Operations, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ _____ 2015)