PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

December 19, 2014
Report No.: AB7669

Operation Name	Energy Sector Development Policy Operation
Region	EUROPE AND CENTRAL ASIA
Country	Kyrgyz Republic
Sector	General energy sector (80%); Energy efficiency in Heat and Power (20%)
Operation ID	P152440
Lending Instrument	Development Policy Lending
Borrower(s)	MINISTRY OF FINANCE
Implementing Agency	MINISTRY OF ENERGY AND IDUSTRY
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I. Key development issues and rationale for Bank involvement

Economic growth has been volatile in the last few years, with a more challenging outlook. Growth averaged around five percent since 2010 with considerable fluctuations due to frequent shocks, including natural (land slide at the largest gold mine), external (food and energy price spikes) as well as political factors (2010 revolution). Most recently, economic growth has moderated in response to weaker growth in Russia, the closure of the Manas Transit Center and a poor harvest. Overall, economic management has been adequate, but continues to rely largely on ad-hoc measures rather than a systemic approach to structural reforms. Economic activity is concentrated in few, low productivity sectors (agriculture, trade) characterized by high informality. Continued sluggish growth in key trading partners and geopolitical factors are likely to limit growth prospects over the next few years.

Volatile growth and frequent price shocks have kept poverty high. A remarkable decline in poverty, from 62.6 percent down to 32 percent, was registered between 2000 and 2008 due to strong growth, additional job creation and surge in remittances. However, frequent shocks in recent years, including food price spikes and political instability, somewhat reversed this trend. In 2013, about 37 percent of the population lived in poverty, and an estimated 2.8 percent of the population lived in extreme poverty. The Kyrgyz Republic remains one of the poorest countries in Europe and Central Asia (ECA) with a GNI per capita of around US$1,200 in 2013. Social safety nets have a limited role in supporting the most vulnerable; although public spending for social transfers account for more than two percent of GDP, only one of the programs is targeting the poor.

Despite its potential, the energy sector is a source of significant vulnerability. The sector suffers from deeply rooted structural issues. The Kyrgyz Republic has the lowest electricity tariffs in the ECA region and one of the lowest worldwide, which contributes to the inefficient

use of energy, severe under-spending on maintenance and new investments, and resulting poor supply reliability and quality. The patchwork regulatory framework, suboptimal contractual arrangements and overall poor transparency and accountability result in operational inefficiencies and undermine public trust. The sector is a source of significant quasi-fiscal deficit, which for the power sector alone exceeds two percent of GDP per year. These underlying weaknesses of the sector, when coupled with cycles of poor hydrology, lead to recurrent winter energy shortages with serious repercussions for the population and the economy. The situation for the 2014/2015 winter is particularly alarming due to the unfavorable hydrological situation and the interruption of gas imports in the south of the country. Expected power shortages equivalent to about 1.5 months of winter power consumption are estimated to translate into economic costs in excess of US$300 million or 4.2 percent of GDP. Due to universal access to electricity, cold climate, large reliance on electric heating and lack of alternatives, power supply is an essential need for the Kyrgyz population. Based on the data from 2009-2010, when the Kyrgyz Republic experienced winter energy shortages of similar magnitude to those expected for the 2014-15 winter, the impact of power shortages are estimated to increase poverty in the range of 2-3 percentage points.

The proposed Energy Sector Development Policy Operation (ESDPO) will support the Government's energy sector reform program, which has gained momentum in the face of imminent winter energy crisis. The program is at the core of the national Power Sector Development Strategy 2012-2015 and is fully aligned with the objectives of the Country Partnership Strategy (CPS) for 2013-2017. The Government has established the legal basis for setting-up an economic regulator and an independent settlement center and has initiated tariff reforms.

The operation is closely aligned with the goals of reducing poverty and boosting shared prosperity. A financially viable energy sector will enable higher investments in modernizing and maintaining the sector, reduce the burden on public finances and improve the reliability of power supply, thus improving the competitiveness of businesses. Previous episodes of growth in the Kyrgyz Republic have been closely associated with poverty reduction and consumption growth of the bottom 40 percent. At the same time, improved reliability of power supply will improve the quality of life for people, especially the poor who have fewer alternatives of copying with power shortages. Accordingly, reforms supported by this operation are expected to contribute to both economic growth and poverty reduction.

II. Proposed Objective(s)

The proposed ESDPO will support the Kyrgyz Republic's reforms aimed at laying the foundations for long-term energy supply reliability. To that end, the objectives of the operation are to improve the financial viability of the energy sector, enhance its governance and accountability while managing the impact of power shortages on poor regions.

III. Preliminary Description

The proposed ESDPO is designed to support Government's Energy Sector Action Plan. The operation will support select reforms of the Government's broader Action Plan with focus

on three policy areas: (i) improving financial viability of the energy sector through tariff reforms; (ii) strengthening sector governance, transparency and accountability through establishment of an economic regulator, adoption of a clearly defined tariff setting methodology, implementation of a performance reporting and monitoring framework, and public outreach and communication; and (iii) managing the impact of power shortages on the poor regions through preparation and implementation of power supply management plans for the regions based on the principles of transparency, equitability, predictability, and preservation of essential services.

The policy areas of the proposed ESDPO are interlinked and essential for addressing energy supply reliability in a sustainable manner. Improved financial viability of the energy sector through power and heating tariff reforms will allow investments in maintenance and system improvements, and procurement of fuel for the combined heat and power plants. The reduction of the gap between the tariffs and the costs of power and heat supply will also improve price signals and create incentives for energy conservation, thus, managing the future demand growth. Strengthened governance, transparency and accountability of the sector will ensure that increased revenues are not mismanaged and lead to improvements of sector operational and financial performance. In addition, more rigorous reporting, monitoring and communication will ensure successful implementation of tariff reforms and broader stakeholder support. Finally, the management of power shortages will ensure that power rationing is equitable across the country and is not to the detriment of poor regions. The ESDPO supported reforms will lay foundations for improving reliability and quality of energy supply, which in turn is important for promoting economic growth, reducing poverty and promoting shared prosperity.

IV. Poverty and Social Impacts and Environment Aspects

Electricity tariff increases are estimated to have a modest impact on household expenditures in 2015. Electricity expenditure in the Kyrgyz Republic, as a share of total expenditures is nearly half of the average for the ECA countries. In order to get the "worst case" scenario, the impact of electricity tariff increases was estimated without a reduction in the power consumption (in volume terms). If this was to occur, the estimated reduction in real household income would be 0.5 percent for the bottom 40 percent. Also, in the case of the Kyrgyz Republic, given the large increase in electricity consumption over the last few years, there may be opportunities available to households to roll back some of their increased usage of electricity.

District heating and hot water tariff increases will have marginal impact on the level of poverty in 2015. The share of heating expenditures in total expenditures increasing from 2.4 percent to 3.2 percent for district heating and from 2.0 to 3.2 percent for hot water for those households connected to district heating – a relatively moderate impact. The decrease in real income is also limited with 0.9 percent for district heating and 1.3 percent for hot water on average for the poorest quintile of the population

At the absence of tariff and governance reforms and without adequate management of power shortages, however, poverty implications will be more severe. In the Kyrgyz Republic, alternatives to power and district heating supply are limited especially for the urban population, who cannot easily switch to other sources of energy. Shortages in power supply will also likely increase the price of alternative fuels such as coal, kerosene, and firewood - which are an

important source for heating and cooking, especially in rural areas. In addition, energy shortages would also indirectly affect small businesses and thus, employment, as they may be unable to afford back-up options for power and heat supply (e.g., diesel generators). While the exact quantitative poverty impact of electricity shortages is difficult to estimate, based on data from 2009-2010 (when the Kyrgyz Republic experienced a similar situation), the poverty rate increased by 2-3 percentage points, due to, among other factors, problems in energy supply.

Environment Aspects

The implementation of the policy actions supported by the proposed DPO is not likely to have significant impact on environment, forests, and natural resources. By supporting measures to put the energy sector on a sustainable development path and to correct distorted price signals, the operation will create incentives for reducing power consumption and efficient use of electricity thus having an overall positive environmental impact.

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