

Public Disclosure Authorized

Economic Monitoring Report

to the Ad Hoc Liaison Committee

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List of Acronyms

AHLC	Ad Hoc Liaison Committee
AML/CFT	Anti-Money Laundering and Combating Financing of Terrorism
CBR	Correspondent Banking Relationships
COGAT	Israel's Coordination for Government Activities
DNA	Detailed Needs Assessment
DFID	United Kingdom- Department for International Development
DISCO	Large Distribution Companies
DNA	Detailed Needs Assessment
EU	European Union
GDP	Gross Domestic Product
GOI	Government of Israel
GPP	Gaza Power Plant
GRM	Gaza Reconstruction Mechanism
HV	High-Voltage
IEC	Israel Electric Corporation
IMF	International Monetary Fund
INGL	Israel Natural Gas Lines
LNG	Liquefied Natural Gas
MoNE	Ministry of National Economy
MTO	Money Transfer Operator
MVC	Municipality and Village Councils'
NIS	New Israeli Sheqel
NORG	National Office for the Reconstruction of Gaza
NPA	National Policy Agenda
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PENRA	Palestinian Energy Natural Resources Authority
PETL	Palestinian Electricity Transmission Company Ltd
PERC	Palestinian Electricity Regulatory Council
PFM	Public Financial Management
PMA	Palestine Monetary Authority
PPA	Power Purchase Agreement
PV	Photovoltaics
RPW	Remittance Prices Worldwide
TCF	trillion cubic feet
TSO	Transmission System Operator
VAT	Value Added Tax
UNRWA	United Nations Relief & Works Agency

Executive Summary

- 1. The Palestinian people face an increasingly uncertain political environment, and an economy that is failing to generate the jobs and incomes that are needed to improve living standards.** Restrictions on trade and the access to resources, along with a decade long blockade of Gaza have led to a continuing decline in the productive base of the economy - with the share of Gross Domestic Product (GDP) in manufacturing halved in the last twenty-five years. Unemployment is now approaching 30 percent on average, with youth unemployment in Gaza twice as high. Although 2016 witnessed an improvement from the economic recession of 2014 - driven by a surge in reconstruction activity in Gaza – this is not sustainable nor sufficient to raise per capita incomes of the Palestinians. Looking forward GDP growth is expected to hover around 3.3 percent leading to a near stagnation in per capita income.¹ Further increases in unemployment are also expected.
- 2. The fiscal position continues to be a source of risk for the economy.** A series of one off receipts in 2016 reduced the size of the fiscal deficit. However, with a continuing decline in donor budget support, the prospects for 2017 are grim, and the Bank projects a historically high financing gap of close to USD0.8 billion. The financing gap has in the past led to additional arrears to the private sector – posing significant risks to the economy – and the size of the current year gap raises the prospect of delayed wage or social assistance payments.
- 3. Risks surrounding the banking sector remain, but there have been positive recent developments.** While the banking sector has been relatively stable, the derisking behavior of the Israeli correspondent banks poses a significant threat. Encouragingly, the Government of Israel (GoI) has provided short term cover for the Israeli banks, and the Palestinian Authority (PA) has been working actively to strengthen its systems to prevent money laundering and the financing of terrorism. Embedding improvements in the systems will be crucial prior to an international assessment that is currently scheduled for 2020. The direct and indirect exposure of the sector to the PA also needs to be monitored by the Palestine Monetary Authority (PMA), although the exposure has stabilized recently.
- 4. The Palestinian economy can only reach its full potential after a resolution on final status is reached, yet there is much more that can be done now to increase growth and improve the situation of the Palestinian people.** Creating a supportive environment for investment in the productive sectors of the economy is critical. Increased investment can enhance the capacity of the economy, inspire entrepreneurial effort, and generate the jobs that are needed – especially for the large numbers of unemployed youth.
- 5. These points have been made at past Ad Hoc Liaison Committee (AHLC) meetings but actions to date have been inadequate.** In this report we have again taken stock of progress in addressing past Bank recommendations to the AHLC and while there are developments, overall progress from the GoI and the PA has been minimal, and the core constraints on the economy remain. In a deteriorating status quo, the effectiveness of donor resources could be enhanced if more decisive policy moves are undertaken by all parties.

¹ Medium term growth projections are produced by the IMF.

6. **What is needed is a paradigm shift with measures from all three parties to create a mutually reinforcing momentum for change:**
- a) **The PA can make policy changes to mitigate risks and enable a more dynamic environment for private sector development, job generation, and growth.** The fiscal risks posed by a USD0.8 billion financing gap are acute. These have to be addressed by taking policy decisions to make government spending more efficient and effective (especially with respect to the payroll and pension payments), and revenue reform is needed to address the weak and inequitable performance of the domestic tax system. Through policy reform the PA can also improve the investment climate to lower the cost of doing business, ensure a level playing field for all investors, and help new (small) companies enter the market.
 - b) **The GoI can improve the situation of the Palestinian people (especially the youth) by fully implementing existing agreements to facilitate movement and access to resources, and addressing the PA's claims on losses on revenues.** It is not in anyone's interest to have high levels of Palestinian unemployment - especially among the youth. Opening up access to Gaza and removing the obstacles to trade, and allowing access to the resources in Area C would help improve the competitiveness of Palestinian businesses and encourage the jobs and investments that are needed. Much can be done to improve the performance of the economy within the existing Paris Protocol agreement and without putting at risk Israel's security. In addition, progress has stalled in addressing the fiscal losses under the Paris Protocol that were identified in our April 2016 report and which could make an important contribution to the PA's fiscal position.
 - c) **International donors can create a supportive environment if there is a greater will to implement the changes that are needed.** Donor support has been on a declining path within a deteriorating status quo – with budget support falling from 32 percent of GDP in 2008 to close to 6 percent in 2016. A resolve on the part of the PA and GoI to address the constraints on the economy would be reinforced by additional donor support. In particular, additional budget support would be critical to assist the PA through the needed fiscal adjustment. There is also a challenge in the short term to create a more positive view of investment in the Palestinian territories. The donor community could help with innovative financing schemes that mitigate the political risks, and act as a catalyst for increased private sector investment.
7. **Against an already bleak economic picture, this report focuses on the energy sector where supply shortages are further constraining growth prospects.** Energy is already severely rationed in Gaza, and restrictions in parts of the West Bank apply during peak periods. World Bank demand projections are for electricity growth of 3.5 percent annually until 2030, with Gaza's electricity needs almost doubling in that period. Increased imports and investment in domestic generation and transmission are critical to allow much needed services to be delivered (to the people of Gaza in particular), and to avoid having economic growth stunted by energy shortages. In particular, the Bank has assessed that addressing energy constraints has the potential to add on average 0.4 percentage points to Gaza's annual GDP growth rate through to 2025.
8. **Private sector investment will be crucial to meeting the energy shortfall but will depend on actions from both the PA and GoI to create a facilitating enabling environment.** The new electricity agreement provides momentum for improving the sector but more is needed. A short term priority is to complete negotiation of the interim power purchase agreement in order to energize the Jenin power station. Opportunities to establish a payment arrangement that allows the 161kV line to Gaza to be connected should also be explored. Beyond these short term measures, it is vital for the PA to address institutional reform to ensure that energy suppliers are paid for their service – which is critical for both

energy imports and investment in generation. On the side of GoI, while authorization has recently been provided for construction of the 161kV line, more can be done to facilitate imports of energy and equipment to Gaza. In the West Bank GoI can do more to ease access to land, to allow distribution companies and the Palestinian Electricity and Transmission Company (PETL) to operate efficiently, enhance transmission efficiency, and facilitate exploitation of efficient solar generation in Area C.

9. **Finally, with respect to the reconstruction of Gaza, donor support has now reached 51 percent of the amount pledged at the Cairo Conference - but further increases will be limited unless there is an improved performance from the largest pledging donors.** By the end of December 2016 total disbursement of pledges had reached USD1.796 billion which is almost USD200 million more than the amount reported in our last update to the end of July 2016. However, the disbursements fell USD1.4 billion short of planned disbursements by this time, and were particularly weak for a number of the largest pledgers at the conference. With most of the small donors now having met their pledge there needs to be a stronger performance from the larger donors. Within the contributions, disbursements in support of the Detailed Needs Assessment (DNA) were only 37 percent of total disbursements, and more effort is needed to ensure that the critical reconstruction needs are addressed. For example, although around 56 percent of partially damaged houses have been repaired by mid-March 2017, only 30 percent of the totally damaged houses have been completed to date. There is a funding gap of USD316 million to start repairing the more than 4,000 totally destroyed and close to 59,000 partially damaged housing units.

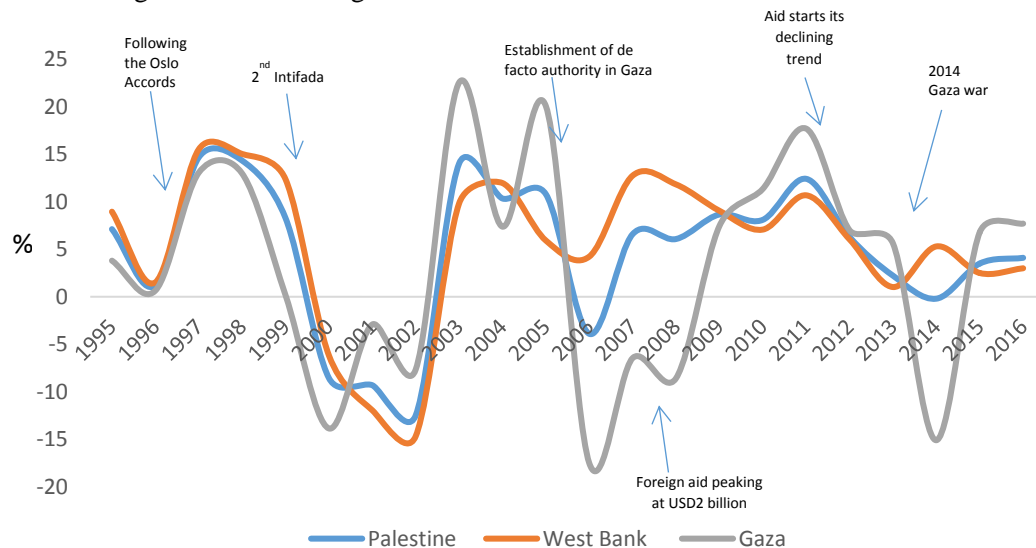
10. **The main body of the report is organized in two chapters with two supporting annexes.** Chapter I focuses on recent economic developments in the real, fiscal and banking sectors, while providing a near term outlook that highlights critical challenges facing the Palestinian economy. Chapter II discusses key challenges in the energy sector with critical messages for GoI, and the PA on steps to create an environment conducive to the needed private sector investment in the sector. Annex 1 assesses the status of the World Bank recommendations to the AHLC meeting over the years. This section is a follow up to the stock take in the September 2016 report to the AHLC, and will be a standard feature of our future reports. In Annex 2 there is an update on the disbursement of pledges made at the Cairo conference in October 2014 on reconstructing Gaza.

I. Recent Developments

A. Growth, unemployment and poverty

11. **The Palestinian economy is suffering from volatile and unsustainable growth.** For such a small economy, achieving a sustainable growth path depends to a large extent on its capacity to compete in regional and global markets and increase its exports of goods and services. The Palestinian economy, however, has been losing this capacity as a result of a poor business climate mainly driven by externally-imposed restrictions on trade and access to resources in addition to the lack of political stability. In fact, the structure of the economy has substantially deteriorated since the 1990's. For instance, the manufacturing sector, which is usually one of the key drivers of export-led growth, has largely stagnated and its share in GDP has dropped from 19 percent in 1994 to 11 percent in 2015. The share of the agriculture sector has also declined from 12 to 4 percent over the same period. In relative terms, most growth occurred in public sector services over the past two decades. Private investment levels, averaging about 15 percent of GDP in recent years, have been low and concentrated in low productivity activities less affected by political risk. Palestinian exports are focused largely on low value added products and services and their share in the economy has been low and stagnant at 17-18 percent. The substantial amounts of financial assistance from the international community received over the last two decades have so far helped mitigate the impact of the restrictions on growth, but aid has significantly declined in recent years (from 32 percent of GDP in 2008 to about 6 percent of GDP in 2016) and cannot continue to substitute for a poor business environment.
12. **Since the Gaza war, the Palestinian economy has grown slowly, albeit driven by unsustainable factors.** The severe economic impact of the Gaza war pushed the Palestinian economy into recession in 2014. Since then, the economy has rebounded with real GDP growth reaching 3.5 percent in 2015 and an estimated 4.1 percent in 2016. Drivers of the recent growth, however, are not sustainable. The latest figures by the Palestinian Central Bureau of Statistics (PCBS) show that growth in the Gaza Strip reached 7.7 percent in 2016 driven by a surge in construction activity following an increase in the amount of construction material entering the Strip. In the West Bank, the economy is estimated to have expanded by 3.0 percent mainly due to an increase in household consumption financed by bank loans.

Figure 1: Real GDP growth rates in the Palestinian territories. 1995 - 2016



Source: Palestine Central Bureau of Statistics

13. **The short term improvement in the Palestinian economy has not led to generation of jobs to absorb all the new labor market entrants, resulting in high and stubborn unemployment.** Over the last two decades, the number of Palestinians in the labor force increased by 800,000, while 500,000 additional formal jobs were created by the private and public sectors. As a result, the number of the unemployed increased significantly, resulting in an extremely high unemployment rate, fluctuating between 20 and 31 percent over the post Oslo period. This poses risks for peace and stability in the sub-region. Most recent data for 2016 shows that the unemployment rate reached 27 percent: 42 percent in Gaza and 18 percent in the West Bank, despite recent steps by the GoI to increase the number of permits for West Bankers.
14. **The Palestinian labor market suffers from structural problems of inclusion particularly for young people and women.** Currently, only 40 percent of those aged between 15 and 29 are active in the labor market, reflecting high pessimism regarding employment prospects. Despite a low participation rate, unemployment amongst this category reached 27 percent in 2016 in the West Bank and a staggering 56 percent in Gaza. Another concern in the Palestinian labor market is related to dramatic differences in labor force participation by gender. Male participation rates reached 71 percent in 2016 (not far from the average in other lower middle income countries), while women have long been under represented in the Palestinian labor market with recent participation rates of 18 percent – compared to an average of 39 percent in other comparators. Anecdotal evidence indicates that mobility restrictions play a key role in keeping Palestinians from entering the labor market, particularly women as it is considered unsafe for them to cross a checkpoint in search for a job. Hence, most women are left with very limited opportunities in their localities discouraging them from joining the labor force. Data also confirms that higher education does not improve employment opportunities for women in the Palestinian territories, while it does for men. In fact, 50 percent of women holding bachelor degrees and higher certificates are unemployed compared to less than ten percent of women with lower educational attainment.

Box 1: Improving the Business Environment

The Ministry of National Economy (MoNE) has been taking concrete steps towards reforming the business enabling environment in the Palestinian territories with support from the World Bank and the Palestinian Market Development Program (funded by United Kingdom- Department for International Development (DfID) and the European Union (EU)).

To ensure a sustained and systematic engagement, the MoNE obtained a Cabinet decision to establish a Ministerial Committee with the mandate of overseeing the implementation of reforms relating to the business environment. The Committee, chaired by the Minister of National Economy, consists of ministers from relevant ministries, the PCBS, in addition to representation from the private sector. Among the first actions taken by the committee was to establish a Technical Committee to implement a reform action plan. The Technical Committee has met several times since its establishment – most recently in March 2017. A series of laws and regulations relevant to the private sector have been identified as priority reform areas, including the Secured Transactions Law, which was signed and enacted in mid-2016, and the new Companies Law which is expected to be approved in 2017. In addition, consideration is being given to the procedures for business licensing, which remain onerous and time consuming due to the clearances required by the relevant authorities, and outdated legislation such as the Law of Crafts and Industries of 1953.

A Citizens Service Center was recently established at the Ramallah Municipality to provide services normally provided by the Municipality (i.e., applying for a construction permit, obtaining a tax clearance, obtaining a business license etc. The Center became operational in January 2017, offering more than 45 services under the Municipality's mandate.

15. **Progress in poverty reduction in the Palestinian territories remains a challenge as political shocks and episodes of conflict frequently erode welfare gains and increase the risk of the vulnerable falling below the poverty line.** Economic growth, social assistance and a well targeted cash transfer program run by the PA have helped reduce poverty in the Palestinian territories in the years following the second Intifada. However, political instability and multiple episodes of war in Gaza over the last ten years have significantly eroded these welfare gains. For example, following the 2008/9 war in Gaza, poverty in the Strip increased by 20 percentage points, pushing up the overall poverty rate in the Palestinian territories. Latest available poverty data is for 2011 and it shows that poverty levels in Gaza were not able to recover to prewar levels, and have remained very high at 38 percent. Poverty in the West Bank, however, was much lower at 18 percent in 2011. This clearly indicates a significant spatial disparity in poverty rates, with a large and widening gap in living standards between the West Bank and Gaza. Poverty rates in Gaza are also more volatile because a large share of Gazans live very close to the poverty line and remains at a constant risk of falling into poverty with any economic shock or episode of war. Given that poverty is highly correlated with labor market outcomes, and given that the unemployment rate has been on the rise in recent years, it is anticipated that poverty levels in the Palestinian territories has increased since 2011, especially in Gaza.
16. **Progress in improving shared prosperity has been stagnant in the Palestinian territories.** Shared prosperity - a concept introduced by the World Bank to promote equity and inclusive growth - is evaluated through progress in achieving faster income growth amongst the bottom 40 percent relative to the rest of the population. According to latest available data, income of the bottom 40 percent of the Palestinian population² has been growing at the same rate as the rest of the distribution. Hence, income levels of the less privileged have not become closer to those earned by the rest of the population, resulting in stagnant shared prosperity.
17. **Given that recent growth has been driven by unsustainable factors, the economic outlook remains worrying with projected growth levels insufficient to improve living standards.** Assuming that the current restrictions remain in place and that the security situation stays relatively calm, the real GDP growth rate of the Palestinian economy in 2017 is projected at 3.4 percent: 2.7 percent in the West Bank and 5.5 percent in Gaza. In the medium term, real GDP growth is projected to hover around 3.3 percent.³ This growth level implies a stagnation in real per capita income and an increase in unemployment. Moreover, downside risks remain significant. First, despite some progress in recent months, setbacks to the reconstruction process in Gaza are possible. The resumption of armed conflict cannot be ruled out and if this happens, the Gaza economy is expected to slip back into recession. Second, the outcome in the West Bank may be worse than expected if the decline in donor support exceeds current projections. Also, if tensions erupt again throughout the West Bank, they will result in elevated security risks that may negatively impact economic activity.

B. Public Finance

While the fiscal performance in 2016 was better than anticipated, this is not sustainable and the Bank projects a substantial financing gap in 2017.

18. **In 2016, public revenue increased by close to 25 percent mainly due to one-off transfers by the GoI and advance telecom license payments.** Following the Israeli-Palestinian ministerial level discussions in early 2016, the GoI transferred to the PA a total of NIS1.2 billion (on a net basis) to offset fiscal leakages accumulated over the years under the existing revenue sharing arrangements

² Given that data on income is not available, consumption per capita was used as a proxy.

³ GDP projections were prepared in consultation with the IMF.

between the two parties.⁴ The PA also received NIS558 million from Paltel, a telecoms operator, as part of the company's license fees for the next twenty years. These one-off payments in addition to higher petroleum excise from Gaza were the main contributors to public revenue growth in 2016, while collections from most domestic tax categories witnessed a decline. For example, income tax and domestic Value Added Tax (VAT) receipts each fell by 8 percent in 2016, and excise on tobacco declined by 6 percent. The key role that one-off payments played in driving revenue growth in 2016 raises sustainability issues and highlights the need for accelerating revenue reform.

19. **Public expenditure growth was high reaching 5 percent mainly due unanticipated wage increases.** The wage bill, the largest spending item, grew by 5 percent in 2016, due to a 1.25 step increase across the board, additional increases for teachers, engineers and security personnel and a net increase in the number of public employees. Data provided by the PA show that public employees increased by 1,047 in 2016, on a net basis, due to additional recruitment in the West Bank (mainly in the education sector) while net employment in Gaza actually decreased last year.⁵ Expenditure growth was also driven by a 7 percent rise in transfers following an increase in social spending in Gaza. Net lending⁶ also grew by 3 percent as Palestinian utility distributors continue to accrue dues to the Israeli suppliers, particularly for water and sewage, while the share of electricity net lending has been maintained at the 2015 level.
20. **Despite a significant decline in the PA's deficit year-on-year, fiscal stress continued to be high in 2016 due to a major drop in budget support.** Strong revenue growth offset the increase in spending and led to a 26 percent decline in the deficit in 2016, which amounted to USD1.09 billion (8 percent of GDP). Aid received reached USD761 million: USD607 in budget support and USD154 million in development financing. Notably, financing received for the PA's development spending in 2016 exceeded its 2015 level by more than two thirds. Receipts for budget support, however, were 16 percent lower year-on-year due to a fall in aid from both Arab as well as international donors. As a result, the PA ended up with a financing gap of about USD330 million (2.5 percent of GDP) and resorted to arrear accumulation to finance it.
21. **According to the 2017 budget, the financing need will remain large.** The budget projects a 14 percent increase in revenues compared to 2016 (after discounting one-offs) mainly due to additional receipts from tobacco taxation from Gaza estimated at USD167 million.⁷ In addition, the PA plans to increase some of the government fees it charges such as licenses for gas stations, and this is expected to generate an additional USD50 million in revenues. Also, installments from the recently signed telecoms deal with Paltel are expected to reach USD75 million in 2016. As for PA expenditure, it is budgeted to decline by 2 percent as a result of a drop in operational spending and net lending by 20 and 8 percent, respectively. In contrast, the wage bill is expected to grow by 3 percent in 2017 despite a decision to maintain a zero net hiring policy. The increase will be driven by a 1.25 step increase that is mandatory by law, retroactive Cost of Living Adjustments for 2015 and 2016 in addition to yearly promotions. The recurrent deficit is projected to reach USD702 million. Development expenditures are expected to total USD427 million, leading to a total deficit of USD1.13 billion (8 percent of GDP).

⁴ The first Israeli transfer was made in early 2016 and amounted to NIS580 million covering some VAT receipts collected on imports to Gaza in addition to a refund on the 3 percent fee charged to handle Palestinian imports. The second transfer was made in September and it covered accumulated Allenby bridge exit fees (NIS58 million) and equalization and health fees collected from Palestinian workers in Israel over the years (NIS593 million), as part of the electricity deal signed between the PA and the GoI.

⁵ According to the PA's employment numbers for 2016, 1965 employees were hired in the West Bank while 926 departed from the labor force in Gaza, on a net basis. The number of employees abroad increased by 8. Net employment in the health and education sectors increased by 302 and 1146, respectively, while it was reduced by 244 in the security sector.

⁶ Net lending represents deductions by the GoI from clearance revenues it collects on behalf of the PA for unpaid utility bills by Palestinian public utilities and local governments.

⁷ The PA plans to license a private tobacco company that will be in charge of all local tobacco sales to Gaza. This company will be located in the West Bank, and taxed by the PA, increasing receipts from tobacco excise from Gaza.

The budget assumes that aid will amount to USD650 million (USD508 million in budget support and USD142 million in development financing), resulting in a financing gap of about USD479 million. The budget assumes that the PA's stock of arrears will be reduced by USD305 million, further widening the financing gap to USD784 million. Unless additional financing sources are identified, the PA's stock of arrears is expected to grow.

22. **The World Bank projects the financing gap for 2017 to approach USD0.8 billion.** The budget revenue target is seen as too high particularly as additional receipts from tobacco taxation are projected to be much lower than the budgeted amount. On the expenditure side, the budgeted decline appears to be optimistic particularly for operational spending and net lending. Therefore, the 2017 deficit could be higher than assumed by the budget at USD1.39 billion, or about 10 percent of GDP. Aid inflows are projected to reach USD661 million, and hence, the size of the financing gap could reach USD772 million (5.6 percent of GDP), prior to any arrear repayment. Notably, this projection has high risks associated with it particularly if some of the planned revenue and expenditure measures do not materialize or if donor aid ends up being even lower than expected.
23. **As mentioned earlier, the financing gap for 2017 is unprecedented in terms of its size, and risks significant economic and social consequences if it is not closed through additional finance or policy measures.** If no additional financing is identified, the PA would need to decide which commitments it can pay. One option would be to accumulate further arrears to the pension fund and private suppliers. Debt to the pension fund already stands at 12 percent of GDP and additional arrears could cause the PA to falter on its dues to pensioners, as the Bank projects that the fund will become insolvent in a few years. The stock of arrears to the private sector currently constitutes about 5 percent of GDP and is highly damaging to the economy. Additional private sector arrears could further worsen the PA's fiscal situation as private companies run out of cash to pay their taxes to the government. An alternative option, would be for the PA to not meet its wage commitments and its social transfers to the poorest of the population. Both options would risk social unrest. These options could also spill to the banking sector if the PA and its employees are unable to repay their loan installments in due time.
24. **While the PA needs to accelerate reforms that align its spending and revenue capacity, in the short term actions by the PA alone will not be enough to close the financing gap, hence the urgent need for additional donor financing.** On top of the above-mentioned planned measures for 2017, the PA needs to limit growth of its wage bill and fully constrain non-priority spending. The results, however, will not be enough to close the 2017 financing gap. Some financing may be available through borrowing from domestic banks as the PA still has some space (about USD160 million) before reaching the limit set by the Palestine Monetary Authority (PMA), but this will also not be sufficient to close the gap. Therefore, in the short term, there is no feasible alternative to budget support as a key source of financing. Donor support during these critical times is essential to sustain reforms and enable provision of services to the Palestinian population. Long term fiscal sustainability, however, cannot be achieved without a prudent and stringent fiscal consolidation program by the PA. This program needs to address reform areas such as the pension system, civil service reform, and untargeted transfers.
25. **Additional actions by the GoI to reduce the PA's fiscal losses under the Paris Protocol will also have significant fiscal benefits.** The Israeli-Palestinian ministerial meetings in early 2016 managed to achieve good progress in clearing a large part of the stock of fiscal leakages owed to the PA. Nevertheless, a systematic mechanism to stop the accumulation of these leakages is yet to be put in place. Efforts should focus on implementing the Paris Protocol's provisions regarding full information sharing on trade that takes place between both parties, including Israeli sales to Gaza. As stipulated by the Protocol, this could be done through setting up an "interconnected computer system" between the Israeli and Palestinian VAT authorities. Moreover, the fee currently charged by the GoI to handle Palestinian imports needs to be revised as the current rate of 3 percent is excessive relative to actual

costs incurred by the Israeli customs authority. These two measures alone would be expected to generate in excess of USD150 million per year in additional revenues for the PA, which would ease the fiscal stress.

Table 1: The Palestinian Authority's Fiscal Operations, 2014-2017

	2014	2015	2016	Budget	Projections
				2017	
USD million					
Total revenues	2744	2754	3452	3503	3297
Total expenditure	4068	3973	4202	4205	4351
Wage expenditure	2050	1912	2052	2108	2108
Nonwage	1732	1816	1881	1850	1983
Net lending	286	301	269	247	260
Recurrent deficit	-1324	-1219	-750	-702	-1055
Development expenditure	262	230	337	427	335
total deficit	-1586	-1449	-1087	-1129	-1390
Financing	1586	1449	1087	1129	1390
Budgetary support	1027	709	607	508	508
Development financing	203	89	154	142	153
Net domestic bank borrowing	-142	163	-5	0	0
Domestic arrears	504	491	327	-300	0
Other	0	0	-2	0	-43
Residual	-6	-3	6	779	772
In percent of GDP					
Total revenues	21.6	21.7	25.8	25.3	23.8
Total expenditure	32.0	31.4	31.4	30.4	31.5
Wage expenditures to GDP	16.1	15.1	15.3	15.2	15.2
Nonwage	13.6	14.3	14.0	13.4	14.3
Net lending	2.3	2.4	2.0	1.8	1.9
Current balance	-10.4	-9.6	-5.6	-5.1	-7.6
Development expenditure	2.1	1.8	2.5	3.1	2.4
Total deficit	-12.5	-11.4	-8.1	-8.2	-10.1
Donor support	9.7	6.3	5.7	4.7	4.8
Financing gap	0.0	0.0	0.0	5.6	5.6
Nominal GDP (in US\$ million)	12697	12673	13397	13826	13826

Source: PA MoFP and WB staff projections

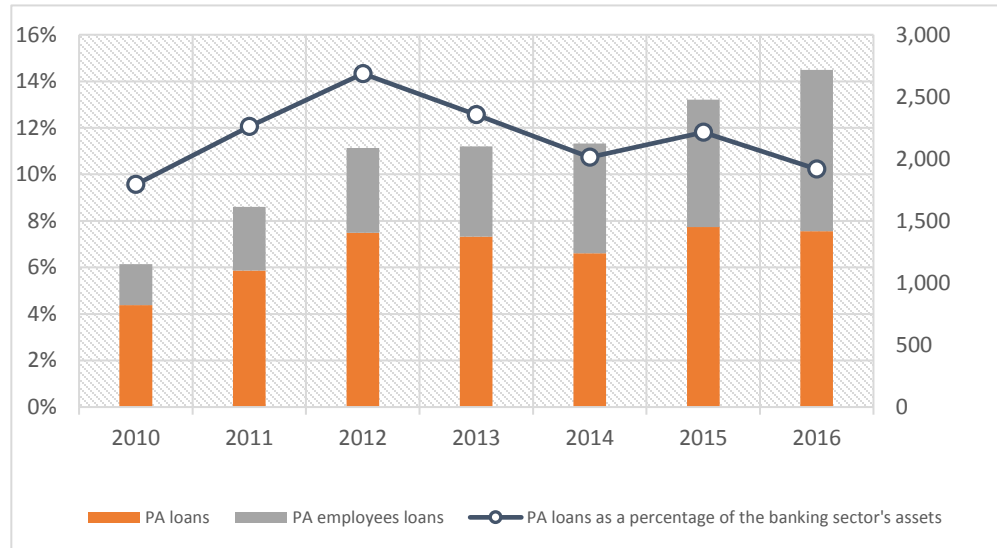
C. Money and Banking

In the context of a difficult economic backdrop, the Palestinian financial sector remains relatively stable but derisking by the correspondent banks is a major challenge.

26. **The Palestinian banking system experienced steady growth in 2016.** PMA data as of December 2016 indicate a 13 percent increase in net assets compared to December 2015, reaching USD13.9 billion. Direct credit grew by just above USD1 billion in 2016, which is consistent with historical growth trends, reaching USD6.8 billion by the end of 2016. Unlike trends in previous years, direct lending to the PA did not experience a net growth, stabilizing at approximately USD1.4 billion, with the bulk of new lending in 2016 going to the private sector. Notwithstanding the growth in credit facilities experienced in 2015 and 2016, the overall credit-to-deposits ratio continued to be within the

regional range, and slightly above the historical range, at 65 percent. Liquidity in the sector remains high as confirmed by both credit-to-deposits ratio and the results of PMA stress testing. In line with the sector's historical data, the banking system maintained its risk averse lending position as reflected by a nonperforming loans ratio of slightly over 2 percent. Despite the high political uncertainty permeating the Palestinian economy, the Palestinian banking sector maintained a profitability in line with previous years, achieving a return-on-equity of 9 percent.

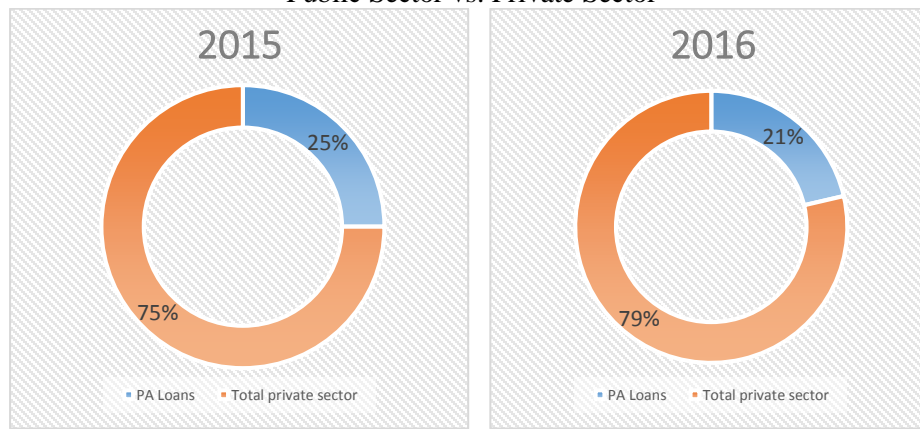
Figure 2: Bank Lending to PA and PA Employees (USD millions)



Source: Palestine Monetary Authority

27. **The Banking system's credit exposure to the public sector moderated in 2016.** Over recent years, the PA's reliance on financing from the banking sector have raised concerns over credit concentration risk. The stock of PA loans was flat in 2016. Total credit grew by approximately USD1 billion from USD5.8 to USD6.8 billion resulting in a decline in the proportion of government loans from 25 percent in 2015 to 21 percent in 2016. The PMA sets an informal PA exposure limit equivalent to the banking sector's total owners' equity. As of December 2016, PA debt is equivalent to 84 percent of the banking sector's total owners' equity. It's important to note that the banking sector's exposure to the PA is not limited to direct credits to the PA. Borrowing by PA employees grew approximately 50 percent over the two-year period of 2015 and 2016, reaching USD1.3 billion. When combined, PA and public employees account for USD2.7 billion, or 40 percent of total banking sector credits.

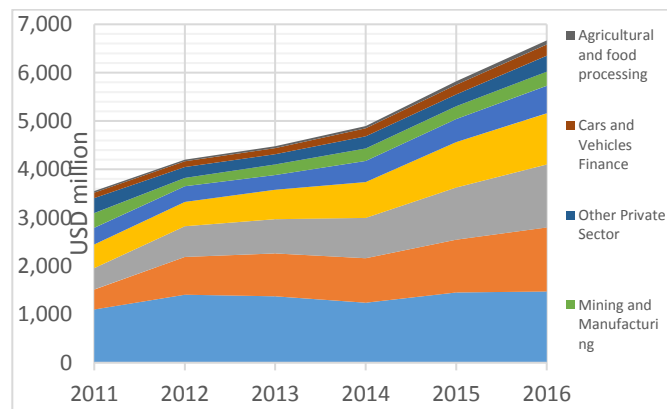
Figure 3: Credit Distribution
Public Sector vs. Private Sector



Source: Palestine Monetary Authority

28. **Secondary exposure channels should be monitored closely.** In addition to the system’s direct exposure to the public sector, the promissory notes program is another channel contributing to the abovementioned exposure. Promissory notes holders have the option to cash-in their debt instrument at a participating local bank, thereby transferring the PA’s debt obligation to the bank – in exchange for a discounted cash payment⁸. As of January 2017, about two thirds of the NIS230 million total stock of outstanding notes were cashed-in and transferred to one of the participating banks, further contributing to the banking system’s exposure to the PA.

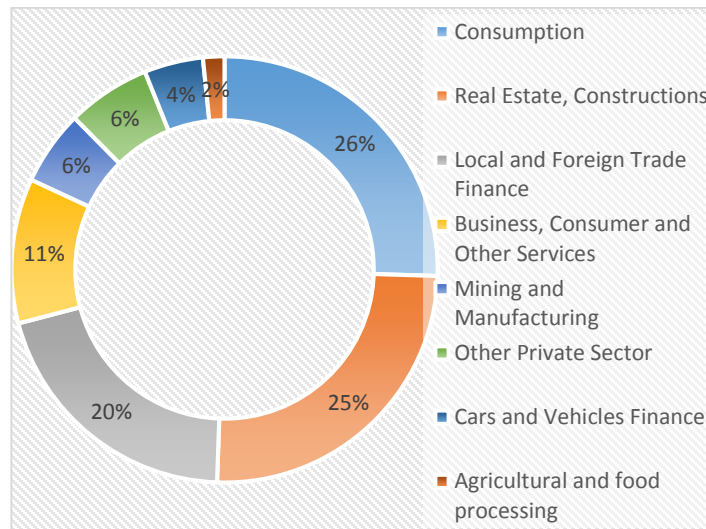
Figure 4: Distribution of Credit Facilities by Economic Sector



Source: Palestine Monetary Authority

⁸ According to the PMA’s guidelines, annual discount rates applied to promissory notes acquired by participating banks are capped at 8 percent for notes issued in NIS, and 6-month LIBOR + 3 percent for notes issued in USD.

Figure 5: Distribution of Private Sector Credit by Economic Activity



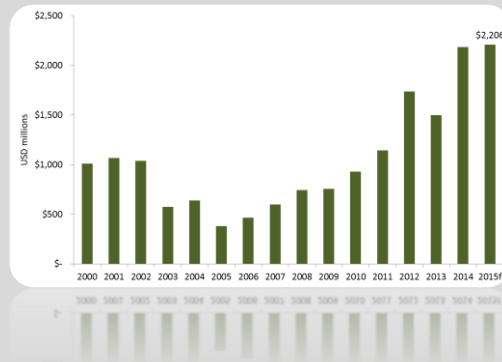
Source: Palestine Monetary Authority

29. **A constant cause for concern for the banking system and the Palestinian economy is the potential negative impact of de-risking by Israeli banks.** Citing money-laundering and financing of terrorism (ML/TF) concerns, key Israeli banks signaled plans to limit or terminate correspondent banking services to Palestinian Banks. Such termination of correspondent banking relationships (CBRs) by Israeli banks could have significant economic impact due to the highly interlinked structure of the two banking systems, and the use of Israeli Shekel as the primary currency in the Palestinian economy. In January 2017, the GoI assumed part of the financial risk by approving an indemnity and immunity package for Israeli banks working with Palestinian banks to alleviate the potential for disruptions to CBRs between the two banking systems. The PMA has also been taking steps, with International Monetary Fund (IMF) and World Bank support, towards upgrading the Palestinian anti-money laundering and combating financing of terrorism (AML/CFT) system to be more in line with international practices.
30. **With technical assistance (TA) from the World Bank, the PA is conducting its first self-assessment of ML/FT risks.** This TA aims to enhance the ability of relevant AML/CFT stakeholders in the Palestinian territories in identifying, assessing and understanding the money laundering and terrorism financing risks they face. Going forward, the authorities will be able to take appropriate measures to manage and mitigate these risks at national and institutional levels and implement a risk-based strategy for AML/CFT in line with international standards. Such a strategy would allow the authorities to target the allocation of resources in high-risk areas, as well as develop simplified AML/CFT requirements in proven low risk areas, including to promote financial inclusion. The risk assessment is being coordinated by the Financial Follow-up Unit, with involvement of the Ministries of Finance and Planning, Justice, Interior, and Foreign Affairs, and the Public Prosecutor’s Office, Customs Services, and other relevant stakeholders. In parallel to the self-assessment process, the PA requested, and has been granted approval for an evaluation of its AML/CFT regime by the regional Financial Action Taskforce (MENAFATF). The evaluation, currently scheduled for 2020, in combination with the self-assessment, represent key milestones towards aligning PA’s AML/CFT systems with international standards.

Box 2: Remittances Market Assessment

The Palestinian territories rank as the second largest source of international migrants in relation to its population in the world, after Syria. The magnitude and importance of remittance inflows to Palestine are undeniable. According to World Bank estimates, remittance inflows to the Palestinian territories were USD2.2 billion in 2015. This estimate does not include compensation of Palestinian employees working in Israel, which, according to the PMA, are an additional USD1.2 billion. Remittance inflows are also significant when considered relative to the size of the economy and other important financial flows. Inward remittances are about 17 percent of GDP, **making the Palestinian territories one of the top 20 most remittance-dependent countries in the world**. If compensation of Palestinian workers in Israel is included, the inward remittance flows rise to 26 percent of GDP. Further, inward remittances are twice as large as exports and comparable to aid including transfers to non-governmental organizations. Remittances exceed Foreign Direct Investment by a factor of 10 to 15.

Figure 6: Officially Reported Inflows to the Palestinian territories



According to the World Bank Remittance Prices Worldwide (RPW) Database, which tracks the cost of sending remittances along 300 corridors, the global average cost of sending USD200 was 7.52 percent in Q1 2016. The cost of sending remittances to the MNA region was recorded at 7.46 percent in the same quarter – broadly in line with the global average cost, but more expensive than in some other regions.

Taking into account that most regulated flows are channeled through Western Union or MoneyGram, the average total cost of sending USD200 to the Palestinian territories via these 2 Money Transfer Operators (MTOs) is equivalent to nearly 12 percent of the amount sent – over USD23 to send USD 200 – and nearly 4 percentage points higher than the global average for MTOs. This average cost includes the cost of cash-to-cash services offered by Western Union and MoneyGram across a small sample of sending countries, including Saudi Arabia, USA, UK and Jordan. **If the cost of sending remittances using MTOs or other providers would be in line with the rest of the world, as indicated by the International MTO Index, the Palestinian economy could have saved USD80 million in 2015 alone.**

Source:

- *The Impact of Remittances on Key Macroeconomic Variables: The Case of Palestine* (Palestine Economic Policy Research Institute, b2015)
- *Remittance Prices Worldwide* available at <https://remittanceprices.worldbank.org/en>
- *World Bank staff estimates*

31. **Results of stress testing by the PMA are in line with previous findings and confirm the banking system’s resilience.** The PMA regularly conducts stress testing, in line with the Basel II principles, to ensure the resilience of the Palestinian banking system against potential shocks. According to the latest available data (December 2016) the PMA reports that the banking system is well capitalized and is able to withstand a wide range of shocks including economic, political and liquidity shocks.

32. **A recent study has highlighted the extent to which the Palestinian territories is dependent on remittances, and the high cost of current arrangements.** The study estimated savings of up to \$80 million per annum if transaction costs were aligned with those of the rest of the world – see Box 2.

II. Securing Energy for Development in The Palestinian territories

With the economy already struggling the development challenges facing the Palestinian energy sector are an important factor when considering the future economic prospects. First, energy is already in short supply with severe rationing in Gaza, and restrictions in parts of the West Bank during peak periods. With further energy demand growth projected, increased imports and investment in domestic generation and transmission are critical to avoid having economic growth stunted by energy shortages. Second, private sector investment will be crucial to meeting the future energy needs. However, this investment will not materialize unless the PA and GoI create a suitable enabling environment. The section examines some of the institutional and access challenges facing the sector, outlines the demand needs and opportunities, and identifies key steps needed to mobilize this investment.

A. *Institutional and Financial Challenges*

33. **Over the last two decades, the Palestinian energy sector has been consolidating, modernizing and strengthening its power sector institutions with sustained support from the international community.** The Palestinian Energy and Natural Resources Authority (PENRA), established in 1995, launched key institutional reforms including the consolidation of numerous small municipality and village councils' (MVC) electricity services into larger distribution companies (DISCOs) to benefit from economies of scale. In 2009 the Palestinian Electricity Regulatory Council (PERC) was established with a mandate of regulating and monitoring the energy sector. In 2013, the Palestinian Electricity Transmission Company Ltd (PETL) was established with a mandate to be the single buyer and Transmission System Operator (TSO) for the Palestinian energy sector. The political division between the PA and the Hamas led authority in Gaza reduces the ability of PENRA, PETL and PERC to exercise their jurisdiction in Gaza.
34. **The electricity sector suffers from operational and financial problems due to high losses and low collection rates.** In 2015, DISCOs in the Palestinian territories billed consumers for 76 percent of the power they purchased from suppliers with the other 24 percent lost and never billed due to the poor state of the infrastructure, and due to illegal connections and theft. Of the electricity billed to consumers, DISCOs collected 84 percent of invoices with 16 percent accumulating as outstanding debt from consumers to DISCOs. Although DISCOs are far from cost recovery, they have seen a major improvement since 2011 when their average losses were 3 percent higher and collection rates 5 percent lower as compared to 2015. It is imperative that DISCOs continue improving their performance so that they can honor the payments to their suppliers and consequently have access to increased power supply.
35. **Bill collection rates are particularly low in Gaza and in refugee camps in the West Bank due to difficult living conditions and a culture of non-payment.** In Gaza, with armed conflict every 2-3 years and the highest unemployment rate in the world at 42 percent,⁹ and a poor quality electricity service, paying electricity bills is not considered a high priority. Refugee camps in the West Bank are

⁹ World Bank press release on May 21, 2015: "Gaza Economy on the Verge of Collapse, Youth Unemployment Highest in the Region at 60 Percent"

also challenging as they have unprecedented levels of per capita consumption but the lowest rate of bill payment. According to a recent survey, underlying reasons for non-payment of electricity bills are the high cost of electricity, low income, poor quality of service, and perceived exemption due to refugee status. Moreover, the poor security conditions in the camps make it difficult for DISCO staff to enter to enforce revenue collection or disconnect service.

36. **The PA has been compelled to subsidize electricity distributors for their non-payment of electricity purchases from Israel Electric Corporation (IEC) through a mechanism known as “net lending”.** Imports of electricity from Israel, which accounted for 99percent of electricity supply in West Bank and 64 percent in Gaza in 2015 – see Table 2. Given weak revenue collection, some DISCOs and MVCs only partially pay for electricity supplied by IEC, while others do not pay at all: preferring to use the collected revenues for financing municipal activities. For years, the PA has indirectly paid a portion of the outstanding bills owed by DISCOs and MVCs to IEC, through a mechanism called ‘net lending’.¹⁰ Outstanding payments owed to the IEC are either (i) deducted from the PA’s clearance revenues by the Israeli Ministry of Finance and registered as “net lending” or (ii) are accumulated as debt owed to the IEC. Net lending reduced the PA’s available revenues by an estimated NIS1 billion in 2012 (USD280 million), representing 13.5 percent of the PA’s total revenues – although actions taken by the PA have reduced the share of revenues to closer to 7.5 percent in 2016. This mechanism sets a precedence in which service providers continue to receive electricity from suppliers, and consumers continue to receive electricity from service providers even if they do not pay their bills, with an assurance that the PA will pay on their behalf reducing a sense of responsibility and accountability.

Table 2: Main sources of electricity in the Palestinian territories, 2015

	West Bank		Gaza		Palestinian territories	
	GWh	Percentage	GWh	Percentage	GWh	Percentage
Total Imports						
• From Israel	4,268	99%	972	64%	5,240	90%
• From Jordan	41	1%	0	0%	41	1%
• From Egypt	0	0%	190	13%	190	3%
Gaza Power Plant	0	0%	355	23%	355	6%
Total	4,309	100%	1,517	100%	5,826	100%

37. **A new electricity agreement between GoI and the PA has settled past debt and plans to pave the way for improvements in the Palestinian energy sector.** As the unpaid portion of outstanding bills from IEC to the Palestinian service providers continued to accumulate year after year, IEC made payment of past debt a pre-condition for energizing new high voltage substations. On September 13, 2016, the PA and the GoI signed an agreement to settle past electricity sector debt, which stood at USD534 million (NIS2.03 billion), and created joint committees to work on three key issues: i) energizing the new high voltage substations to bring more power to the West Bank, ii) signature of a long term Power Purchase Agreement (PPA) at a lower wholesale tariff rate, and iii) transfer of over 250 connection points to PETL in order to have a single point of transaction (single-buyer) between Israeli and Palestinian sides. A key determinant of the success of the new electricity agreement will be

¹⁰ As explained earlier, ‘Net lending’ refers to the process by which Israel deducts a portion of unpaid electricity bills, owed by Palestinian distributors, to the IEC – which supplies over 95percent of the energy to WBG. This process essentially forces the PA to indirectly pay for the outstanding bills of distribution companies through collection revenues destined for the national budget. The PA considers this payment to be on behalf of the distributor and reports this as “net lending” reflecting an obligation from the distributor to the PA.

the ability of PETL to pay for 100 percent of the power purchased from IEC. In turn, DISCOs and end consumers need to follow-suit along the value chain. This requires major cultural and behavioral change and a strong commitment from the PA and PENRA to increase accountability and enhance transparency in the electricity revenue cycle.

38. **In the short term, a priority of the two parties is to sign an interim PPA to energize the new high voltage Jenin substation.** In view of the dire need of additional electricity supply in the north of the West Bank, the negotiating parties have agreed in good faith to initially complete an interim PPA for the Jenin substation whose immediate energization is critical to avoid power shortages during the upcoming summer. An interim agreement would unlock a series of positive outcomes that would help move the Palestinian energy sector past its current impasse and set the scene for future negotiations on the larger and longer term PPA. The signature of the interim PPA and energization of the Jenin substation would not only bring desperately needed additional power supply to the West Bank, but also provide at least a 10 percent discount simply by switching from medium to a high voltage tariff. In addition, receiving power at the high voltage level would reduce the losses from the oversaturated medium voltage network enabling DISCOs to bill for a larger portion of the purchased power. Finally, the most immediate result will be in avoiding mass protests and civil unrest during the coming summer peak load as was seen during the past winter peak load which resulted in power cuts in the Northern West Bank.
39. **PETL must start operating on a commercial basis and take ownership for fixing the gaps in the revenue cycle as their first priority.** PETL is expected to be financially self-sufficient following the energization of the substations in the West Bank. At that point PETL would be able to purchase cheaper power at high voltage levels from IEC and sell it to Palestinian distributors. The entire value chain suffers from extensive leakages which significantly undermine the sector's ability to gain financial independence. Once the value chain becomes more efficient, PETL would generate revenues and become operationally sustainable, which would attract Independent Power Producers to sign PPAs with PETL allowing the Palestinian energy sector to increase diversification and independence. The current Palestinian sales tariffs need to be reviewed in order to ensure cost recovery while keeping in mind that the poor and vulnerable need to be protected.

B. Energy Security Issues

40. **The Palestinian territories face significant energy security challenges, already severe in Gaza, but also emerging in the West Bank.** Limited power supply is rationed through rolling black outs which are increasing in frequency in the West Bank and in duration in Gaza. In Gaza, the available power supply only meets half the demand resulting in the rationing of power through rolling blackouts with 8 hours of power supply followed by 8 hours of power cuts. During peak summer and winter load conditions, the power schedule is reduced to 3-4 hours per day. Although the West Bank generally enjoys 24 hours of power supply, in recent years it has also begun experiencing power shortages during peak winter and summer months. Electricity shortages in both West Bank and Gaza are often met with mass protests and demonstrations.
41. **Options for expanding electricity supply have been quite constrained.** In the West Bank, the energization of new substations that will bring an additional 600 MVA of power from Israel is pending the agreement of a new PPA between the IEC and PETL, following the recent settlement of a longstanding debt problem, as mentioned above. In Gaza, despite recent Israeli approval, the

completion of an additional 161 kV interconnector with Israel has been on hold for a long time as the responsibility and mechanism for payment of purchased electricity are being decided.

42. **Meanwhile, electricity demand continues to grow; potentially doubling in Gaza by 2030.** Electricity demand in the Palestinian territories has been growing at an annual rate of 7.2 percent from 2001-2013. Due to projected lower GDP growth, forecast demand growth for 2016-2030 is significantly lower at 3.5 percent, though much higher in Gaza (4.9 percent) than the West Bank (2.9 percent) owing to the need to satisfy current suppressed demand estimated at about 36 percent of existing consumption in Gaza. The implication is that Gaza's electricity needs will almost double by 2030.
43. **Without a timely resolution of energy constraints, economic recovery in the Palestinian territories will be stunted.** The results of an economic modeling exercise for the Palestinian territories show that addressing energy constraints is an important element in promoting economic growth in the Palestinian territories which has the potential to add on average 0.4 percentage points to Gaza's annual GDP growth rate through to 2025. According to recent enterprise surveys, 47 percent of firms in Gaza rely on their own gasoline or diesel-based generators for about 42 percent of their energy needs. Running such generators is estimated to cost upwards of \$0.75 per kilowatt-hour or about five times the current utility tariff.

C. Pathways to Enhance Energy Security

Improving energy security will entail increasing, and possibly diversifying imports, as well as developing further domestic generation capacity.

Increasing and Diversifying Imports

44. **Israel will likely continue to be a major source of electricity for the Palestinian territories.** The IEC is the main supplier of electricity both to the West Bank and Gaza at a rate of \$0.09-\$0.10/kWh. IEC supplies electricity to the West Bank through more than 250 separate low and medium voltage connection points most of which are nearing saturation. Investments in four high voltage substations will allow more Israeli imports to the West Bank from IEC. In Gaza, IEC supplies electricity through 10 connection points; however, all import feeder lines are completely saturated and cannot transmit any more power. Israeli and Palestinian sides are discussing the possibility of extending a 161 kV transmission line to Gaza which would bring an additional 100-120MW of power to the strip.
45. **The increasing weight of Palestinian electricity consumption on IEC's balance sheet could exacerbate the company's existing debt problems.** The share of Israeli Independent Power Producers in the total Israeli power production increased from 1 percent in 2009 to 16 percent in 2014, and is estimated to reach 40 percent by 2020. As Israeli demand shifts away from IEC towards Independent Power Producers, Palestinian demand – already IEC's largest and most rapidly growing customer – will carry increasing weight in the company's revenue stream. IEC already suffers from a large accumulated debt primarily from the Israeli electricity sector. Any accumulation of additional debt from the growing Palestinian consumers will be harmful to the company's bottom line.
46. **Diversification of electricity supply from other neighboring countries needs to be pursued but is hindered by problems of land access, security and payment risk.** The West Bank already obtains 1 percent of its electricity from Jordan, while Gaza obtains 13 percent from Egypt. Both neighboring countries have gone through recent power supply crises, but both are also emerging with major

investments in generation that will lead to significant reserves. In principle, existing interconnectors of 20 MW with Jordan and 30 MW with Egypt could be upgraded to supply additional electricity. Jordanian power, generated largely from liquefied natural gas (LNG) at present, is significantly more expensive than the IEC, currently at \$0.14-\$0.15/kWh. This cost is expected to come down as Israeli natural gas reaches Jordanian power stations and additional solar power plants come online. However, restrictions of access and construction in Area C are major obstacles to build and upgrade interconnectors with Jordan. The cost of electricity generation in Egypt is potentially more competitive than Jordan; however, security issues in Sinai affect the reliability of this source. For both Egyptian and Jordanian supply, the lack of payment security presents a major risk as neither country has access to the 'net lending' mechanism available to Israel to compensate for default on payments. Currently, the power supply from Egypt is paid for, in large part, by donations through the Arab League on a rolling basis.

Among domestic generation possibilities, the two key options are natural gas and renewable energy.

Expanding Natural Gas Possibilities

47. **At present, only Gaza has any significant domestic generation capacity, but this has become a significant financial burden which affects the provision of electricity.** While the Gaza Power Plant (GPP) provides 23 percent of Gaza's total energy supply, it runs on expensive diesel fuel. In addition to the cost of fuel, the GPP PPA stipulates that a capacity charge payment must be paid regardless of the level of operation of the plant. It costs almost 3 times more to produce 1KWh from GPP than to import 1KWh from IEC. In terms of repairs and operation and maintenance, GPP faces major obstacles as specialized spare parts and chemicals, as well as expert technicians, must be brought to Gaza from abroad. This is especially difficult considering the blockade on Gaza.
48. **The additional 161kV power line from IEC to Gaza would bring much needed relief; however, the question of payment has not been resolved.** Currently, the PA pays for all electricity imports to Gaza from IEC. Any additional power imports would lead to higher levels of net lending without any promise that increased revenues collected from consumers in Gaza would be passed on to the PA. Until an agreement is reached between the PA and Hamas in Gaza on the transfer of collected bill revenues additional power supply to Gaza from IEC will face a roadblock.
49. **Given the abundance of local natural gas resources, bringing gas to both the West Bank and Gaza is now feasible.** The Israeli gas market, already well-developed as a result of the Tamar field, is poised to expand considerably as the much larger Leviathan field commences production. Tamar (reserve of 10.9 trillion cubic feet (TCF)), Leviathan (reserve of 21.9 TCF) and a handful of other Israeli gas fields with a total combined reserve of 38.2 TCF are more than enough to fully meet Israeli gas demand and export excess to neighboring countries. The Israeli government has already given its approval for natural gas to be transported within 15 kilometers of Jenin in the north of the West Bank using the Israeli domestic gas transportation network Israel Natural Gas Lines (INGL), from where it could be delivered through the construction of a small spur. A project to extend a modest 20 kilometer gas pipeline from Ashkelon in Israel to the Gaza Power Plant is also under preparation.
50. **The arrival of natural gas to the Palestinian territories could bring significant advantages.** In the case of Gaza, the plan would be to convert the Gaza Power Plant from diesel to natural gas, which would allow the cost of generation to fall significantly from current levels of around \$0.30-\$0.40/kWh

to \$0.10-0.13/kWh, resulting in savings of USD45 million per year, and making a further expansion of capacity a potentially attractive option. In the case of the West Bank, the construction of a 450 MW combined cycle gas-fired power generation plant is already in the planning stages at Jenin in the north of the West Bank.

51. **Eventual development of the Palestinians' own gas field – Gaza Marine – would further add to Palestinian energy security as well as boosting fiscal revenues.** Since 2000, it has been known that 1.3 TCF of proven natural gas reserves lie 36 kilometers off-shore of Gaza in the Gaza Marine field. Given the size of the field, its development would currently require the identification of markets that go beyond the Palestinian electricity sector. Although as gas-fired power generation capacity is developed in the Palestinian territories, gas demand could grow from 0.35 billion cubic meters per year to 1.00 billion cubic meters by 2030.¹¹ A higher level of domestic demand could help to underwrite the development of the field. In addition, the development of Gaza Marine could generate a significant income stream to the PA from taxes and royalties.

Harnessing Renewable Energy

52. **As the cost of solar energy continues to decline, the option looks increasingly attractive for the Palestinian territories.** Since 2009, the cost of utility scale and residential solar Photovoltaics (PV) has dropped more than 80¹² percent with neighboring Jordan receiving bids as low as \$0.06/KWh which is equal to half the price of IEC imports. The Palestinian territories are located in a region rich with the sun's energy with large potential in exploring the yet untapped solar sector. In fact, solar energy represents the only truly independent form of power supply which does not rely on imports of fuel or electricity and brings wider environmental benefits.
53. **Land availability is however a major constraint for tapping into solar energy production.** In the West Bank, access to land for solar power generation is a problem since most of the land suitable for ground-based solar PV is located outside the heavily populated Area A. In particular, Area C has significant potential for large-scale roll out of ground-based solar PV plants; however, access to this land is severely limited. In Gaza, due to the small size and high population density, the potential for ground-based solar PV is small. Given the land scarcity, rooftop solar may provide an attractive scalable alternative that could reach several tens of MW in the Palestinian territories.

Developing Transmission Infrastructure

54. **As domestic generation develops, Israeli and Palestinian sides must work together to decide the best mode of evacuation through the power grid.** The transfer of bulk energy between the IEC's power plants and Palestinian consumption centers has remained under IEC's responsibility through its high voltage transmission network. The Palestinian electricity distributors have been importing power from IEC through low and medium voltage connection points, but this is about to change. The energization of the high-voltage substations under PETL's management will start a consolidation process of the existing connection points. Palestinian territories have not previously had any high voltage transmission infrastructure, but rather focused only on low and medium voltage local distribution. To create a Palestinian high voltage transmission network that would evacuate domestic Palestinian generation, large and contiguous infrastructure would need to be built traversing Areas A,

¹¹ In 2016 natural gas demand in Israel accumulated to some 9.5 BCM and in Jordan to 3 BCM (estimates).

¹² IRENA renewable cost database 2014

B and C. Logistically and operationally this would be a complex endeavor requiring construction permits at multiple locations, interconnection studies to identify impact on neighboring power grids, agreements on grid operation and supply-demand balancing with neighboring transmission system operators.

55. **In the short to medium term, the two sides could agree on wheeling arrangements to use the Israeli transmission to minimize the transmission costs and ensure that power supply expansion continues to grow as a top priority in order to keep pace with demand growth.** In the longer term, as the Palestinian energy sector becomes more stable and bankable, the two sides can work together to build a long term vision of establishing a high voltage transmission network. Given the inherently interwoven nature of the Israeli and Palestinian energy sectors, with or without a Palestinian transmission network, both sides must rely on each other to ensure grid stability.

Investment Needs and Constraints

56. **The overall investment needs associated with improving energy security in the Palestinian territories amount to USD2-3 billion through to 2030.** Of this, about 90 percent is related to power generation and 10 percent to network infrastructure. The 90 percent related to power generation, which would include gas fired generation and solar farms, could potentially be private sector financed. The remaining 10 percent of power sector investment needs for enforcing and expanding the local distribution network would need to be publically financed. Given the weak financial position of the sector, these investment needs would entail donor support.
57. **Attracting private sector financing for the development of energy projects in Palestine, however, depends critically on the creditworthiness of PETL.** The ability to raise private capital at reasonable cost depends on keeping the risks of these projects at a tolerable level. The largest risk associated with these types of contracts is the payment risk associated with the PPA, which in turn depends critically on the creditworthiness of the off-taker PETL. While it may be possible to mitigate this risk to some extent in the short term through credit enhancements of various kinds, such as guarantees, this will further increase the financing cost and is no substitute for an improvement in the sector fundamentals.

D. Key Messages

58. **The reforms in the Palestinian electricity sector during the last two decades have laid the foundations to move towards clean, abundant and affordable electricity services.** To achieve these objectives, however, significant changes are still required. The reforms spearheaded by PENRA, with the support of the donor community, have included the creation of new institutions, i.e. a DISCO to consolidate fragmented power supply in the north of the West Bank; an electricity regulator (PERC) to stabilize the sector and a public company (PETL) to transmit the electricity from the source –imported or domestic- to distribution entities. The deployment of technological solutions combined with resolute government action have improved the collection rate of customer’s electricity bills by DISCOs to over 80 percent on average. Despite these achievements, the reforms need to be accelerated and sustained in order to achieve private sector-led transformational impact.

59. **Major reforms in the Israeli power market bring further opportunities for shaping the future of the power trade with the Palestinian territories.** The Israeli electricity sector is in the midst of a major power sector reform process, partly in response to the chronic accumulation of debts by IEC. Independent Power Producers are providing a growing share of the Israeli market and as Israeli demand shifts away from IEC, Palestinian demand – already IEC’s largest and most rapidly growing customer – will carry increasing weight in the company’s revenue stream. Although, in the future the Palestinians could also consider purchasing power directly from Israeli Independent Power Producers.
60. **A new electricity debt agreement between the GoI and the PA provides momentum for improving the Palestinian electricity sector.** In September 2016, the PA and the GoI signed an agreement to settle around USD550 million of past debt owed by the Palestinian electricity distributors to the IEC. The agreement of a long-term PPA between IEC and PETL at a lower wholesale tariff was identified as a priority, as well as the energization of new high voltage substations built in the West Bank. In view of the dire need for electricity supply in the north of the West Bank the parties have agreed to initially complete an interim PPA for the Jenin substation. The signature of the main long term PPA is expected to follow suit and relieve the West Bank from a looming energy crisis.
61. **Improving the creditworthiness and payment discipline along the electricity supply chain is a pre-requisite for harnessing private investments to increase electricity supply.** Palestinian electricity distributors have a poor payment track record to their main supplier, IEC, which is not conducive to attracting private capital to develop new generation projects. The improvement of the DISCOs operational and commercial performance is a first step towards increasing their payment capacity and service improvements. Following the signature of the interim PPA, attention can be focused on the management of PETL as a commercial company in order to strengthen the company’s credibility vis-à-vis electricity suppliers, including IEC. PERC can review the current electricity tariff methodology and structure, including affordability issues, to ensure that the cost of developing the sector are transparently passed on to consumers. Moreover, the PA needs to continue its efforts to improve the municipal finances to prevent further diversion of electricity revenues to broader local government expenditures. This may require additional revenue sources for MVCs, including a regular fiscal transfer, but also increasing expenditure efficiency in basic local service delivery.
62. **Easing the access to land for Palestinians would help to improve the efficiency of the electricity sector.** Restrictions on access to land prevents Palestinian DISCOs and other electricity distributors from operating their businesses efficiently. The lack of access to Area C, which constitutes most of the land area in the West Bank, represents a major missed opportunity for the development of renewable energies.
63. **In Gaza, in the short term, the construction of a high-voltage (HV) line from Israel to Gaza is a low-hanging fruit that could relieve the energy crisis.** Despite having the necessary authorizations from the Israeli government, construction of a new HV line has not started yet. The uncertainties around payment obligations of purchased power through this new infrastructure could be reduced by increasing the imports to Gaza in gradual phases. In the mid-term, the scale-up of solar rooftop photovoltaic could be a more reliable and affordable solution to existing alternatives to keep the lights on. The conversion of the Gaza Power Plant to gas, together with investments in transmission infrastructure, would lead to a significant increase in power supply for the population and savings for the government.

64. **Transformation of the PA energy institutions is critical to enable key energy sector development in the Palestinian territories and to reduce the debt with IEC.** Transforming the Palestinian energy sector depends in part on enhancing and motivating institutions to fulfill their roles in a restructured sectoral environment. While reform must be policy based, it also needs to be pragmatic and reflect operational realities. Enhancing the transparency of information and fostering an accountability environment among key stakeholders would also help to create the right incentives. While outside help can facilitate change, the leadership for change must come from within. PETL, DISCOs, municipalities and the PA must believe in the process of change, own it and internalize it in order to make reform work. Finally, the PA must maintain its will to see a commercially self-sufficient power sector. By embracing constructive change in the power sector, the government has yet another opportunity to make a tangible and measurable improvement in the lives of Palestinians by providing affordable and reliable electricity, supporting economic development, and freeing up the large sums now spent on subsidies so they can be applied to better social purposes.

Annex 1: Stock take of World Bank Recommendations to the AHLC meeting

65. **As identified in Chapter I, the Palestinian economic outlook is worrying and renewed efforts are needed by the PA, the GoI and the donor community.** Until there is a permanent peace agreement, the Palestinian economy will continue to perform below its potential and this will impact the economic and fiscal performance. However, there is more that can be done to enhance the performance of the Palestinian economy and improve the fiscal situation.
66. **Many needed actions have been identified in previous reports by the World Bank to the AHLC meeting but implementation of these measures has been limited.** In our 2016 report to the AHLC we conducted a stock taking of all previous World Bank recommendations to the meeting. The stock take was intended to provide a baseline for evaluating progress in achieving the Palestinian territories' development priorities. In addition, it was hoped that it would galvanize the reform efforts of all parties to address the immediate crisis while setting in place reforms that will deliver over time.
67. **In this report we have updated the stock take to show progress since September 2016 using the same three pillars 1) fiscal sustainability, 2) economic development and 3) Gaza reconstruction and recovery.** Many of the PA actions are foreshadowed in the National Policy Agenda (NPA) which was released in February 2017. The main developments in these pillars are:

Fiscal Sustainability

68. **While the fiscal performance was stronger in 2016 this was largely driven by one off revenue receipts and there has been little progress on the structural reforms needed to achieve fiscal sustainability.** On the expenditure side there has been some progress on controlling health referrals with the arrangements earlier developed for Israeli hospitals now extended to six East Jerusalem hospitals and three West Bank hospitals. Progress has also been made on steps to control electricity net lending – although the problem is now emerging with other utility payments. There has been a recent step to reduce payments to Gazan employees, but these have not been formalized and while there is policy work underway, there have been no structural changes to control the wage bill or implement parametric reforms to support the pension systems sustainability.
69. **On the revenue side progress has stalled since the initial one off payments by Israel to address past fiscal leakages.** Immediate areas of focus are the handling fee, the crossing fees and systematic transfer of the health and equalization levies. To date there has not been a positive GoI response to requests in these areas, although proposed senior official talks are a promising development. Talks are also now underway between GoI and the PA to initiate the introduction of bonded warehouses for Palestinian imports and the transfer of some customs authority to the PA over the coming years. This is a potentially positive development, although care will be needed in the implementation to ensure that the revenues are protected and no additional costs are imposed on the Palestinian private sector. However, these talks should not be at the expense of addressing the real issues on fiscal losses identified earlier.
70. **Finally, efforts to boost domestic revenues have been inadequate and the domestic revenue performance has been extremely weak.** In fact, growth in domestic tax receipts has been lower than GDP growth in 2016, which highlights the need for revenue reform. The 2017 budget included an increase in various administrative fees and charges which is a positive step. However, on the broader tax system, even though the PA has focused its efforts on increasing the number of taxpayers, this has not translated into an increase in tax collections. The failure is because the majority of those newly added are low earners and the cost to administer their tax files is high. A focus on increasing the number of large taxpayers, particularly high earning professionals, would be more productive. Alongside this

more could be done to change the basic approach to tax administration by placing the onus on taxpayers to comply with the system, and applying penalties for non-compliance. This approach has been successful in other countries.

71. **There has not been any material progress in improving the public financial management (PFM) system in recent months, although the PA has in that period prepared its first comprehensive PFM strategy.** It is intended that this will guide a more active reform agenda in the coming years.
72. **Budget support from donors has continued to decline and this has been a key factor behind the large financing gap.** As a share of GDP budget support has fallen from 32 percent in 2008 to under 6 percent in 2016. The PA has budgeted for a further fall to under 5 percent in 2017.

Economic Development

73. **The GoI constraints on movement and access continue to be the main impediment to economic growth leading to a sustainable recovery.** A recent report from Israeli and Palestinian academics¹³ highlighted the potential for economic development in both Gaza and the Jordan Valley, which recognizes Israel's security concerns and does not interfere with final status negotiations. With respect to Gaza the report includes proposals for a new deep water port, a link between Gaza and the West Bank, and the opening of Rafah for trade, with mitigating measures to address security concerns. For the Jordan Valley, there are proposals to ease planning restrictions on land, increase Palestinian access to water, and encourage investment in agriculture, tourism and industry.
74. **At a domestic level, the PA has initiated steps to reduce the cost of doing business and improve the business climate but these have yet to be fully implemented.** A draft Companies Law has been developed following extensive consultation, and is expected to be passed into law during 2017. Similarly, a draft competition law has been prepared although the timing of its implementation is less clear. The abolition of land titling fees has led to an increase in land registration while consideration is also being given to new institutional arrangements to accelerate land registration but no decisions have yet been made.





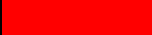
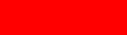




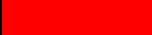
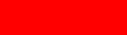


Gaza Reconstruction and Recovery

75. **Gaza reconstruction is progressing, although too slowly.** While good progress has been made in some sectors, such as in the water sector in which reconstruction is almost completed, the transition to recovery is slow given the limits on funding and material entry. Disbursements after the Cairo conference in October 2014 have reached a plateau at around 50 percent which is causing a funding shortage that curtails progress particularly in those sectors with the highest financing needs identified in the DNA, e.g., in the housing sector. Good progress has been made in developing a results tracking mechanism to complement the pledge tracking under the leadership of the National Office for the Reconstruction of Gaza (NORG). However, more needs to be done to strengthen NORG's institutional set-up and ensure a sustainable financing arrangement embedded in the PA's structure. The shortage of materials remains an issue and despite the requests the Gaza Reconstruction Mechanism (GRM) has been able to process under the shelter and residential stream, progress and workability of the system for more complex infrastructure projects remains limited. Interruptions and long delays remain prevalent and no delivery monitoring has been established yet.




¹³ The AIX Group: "Improving the Gazan Economy and Utilizing the Economic Potential of the Jordan Valley" 2017.

Table 3: Summary of World Bank recommendations to prior AHLC meetings

Actions	Responsible Party	Progress Sept 2016	As of April 2017
<u>FISCAL SUSTAINABILITY</u>			
Expenditures			
Control the oversized wage bill	PA	Red	Red
Control medical referrals to Israel	PA	Green	Green
Control medical referrals to local facilities	PA	Red	Yellow
Implement administrative reforms for the pension system	PA	Green	Green
Implement parametric reforms to restore the pension system's sustainability	PA	Red	Red
Reduce the size of net lending	PA	Yellow	Yellow
Revenues			
Enhance the PA's tax effectiveness in Gaza	PA	Red	Red
Increase the number of registered large taxpayers	PA	Yellow	Yellow
Strengthen legislation to penalize non-compliant taxpayers	PA	Red	Red
Revise government fees and charges upwards	PA	Red	Yellow
Transfer to the PA fiscal losses accumulated over the years	GoI	Yellow	Yellow
Implement institutional measures to reduce fiscal losses on clearance revenues	PA and GoI	Red	Red
Public Financial Management			
Improve budget preparation procedures	PA	Yellow	Yellow
Align budget execution with available resources	PA	Yellow	Yellow
Clear the backlog of outstanding financial statements 2012-2015	PA	Red	Red
Develop systems for monitoring and reporting expenditure arrears	PA	Green	Green
Budget support			
Provide sizeable, predictable and timely support to the PA's budget	Donors	Yellow	Red
<u>ECONOMIC DEVELOPMENT</u>			
Area C			
Expand spatial plans for Palestinian villages in Area C	GoI	Red	Red
Increase number of building permits approved in Area C	GoI	Red	Red
Grant approval to Palestinian business projects in Area C	GoI	Red	Red
The Gaza economy			
Allow exports out of Gaza to reach pre-2007 level	GoI	Red	Red
Significantly reduce items on restricted dual use list for Gaza	GoI	Red	Red
Create a unified PA in both the West Bank and in Gaza	PA	Red	Red
The business climate			
Adopt the Secured Transactions Law & establish a movable asset registry	PA	Green	Green
Adopt the new Companies Law & the Competition Law	PA	Red	Yellow
Accelerate land registration in Areas A and B	PA	Red	Yellow
Improve access to finance for SMEs	PA	Yellow	Yellow
Reform the education system to bridge gap between graduates' skills and labor market needs	PA	Yellow	Yellow

Actions	Responsible Party	Progress Sept 2016	As of April 2017
<u>GAZA RECONSTRUCTION AND RECOVERY</u>			
Complete a DNA to guide reconstruction and recovery	PA		
Accelerate disbursements of Cairo Conference pledges	Donors		
Establish and monitor time line indicators for review and approval of dual use items	GoI		
Include delivery monitoring in GRM system	GoI and PA		
Set-up results-based tracking program to monitor recovery	PA		
Establish Gaza import mechanism able to handle Gaza's long term recovery needs	GoI		
Strengthen NORG and institutional structure for cross-sector coordination of decentralized recovery planning	PA		

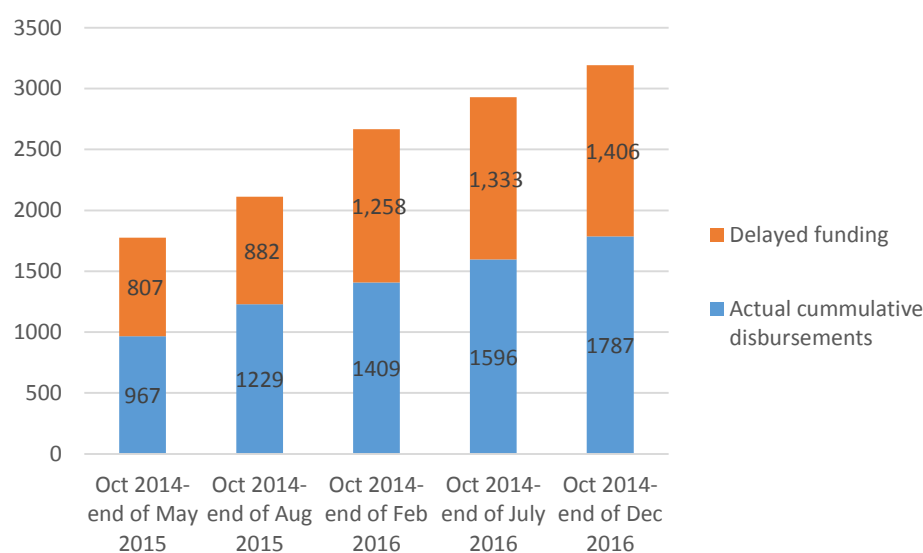
Legend

	On track
	Some progress achieved
	No progress

Annex 2: An overview of disbursement of pledges made at the Cairo Conference on Palestine “Reconstructing Gaza”, Cairo 12th October, 2014

1. **By the end of 2016, almost two years and a half post the 2014 Gaza war, total disbursement of pledges to support Gaza is estimated at USD1.796 billion,¹⁴ and the overall disbursement ratio reached 51 percent.** Based on available data, 31 participants, out of the total 53 participants, have already fully delivered their original pledge at Cairo Conference to support Gaza. However, these are generally the smaller donors and their overall disbursements (USD858 million) represent only a quarter of the overall support to Gaza announced at the Conference. Total disbursements to date by the top 7 donors amounted to USD1.128 billion – and represents only 41 percent of their total original pledge.¹⁵
2. **Actual disbursements as of end of 2016 fell short of planned disbursements by USD1.4 billion.** Figure 1 below shows the actual and expected flow of funding of Support to Gaza over the period 2014-2016. The disbursement ratio by the end of 2016 was supposed to reach around 91 percent as opposed to the actual disbursement ratio of 51 percent by the end of 2016.

Figure 7: Planned Disbursements of Cairo Conference Pledges (2014-2016) in USD million



Source: World Bank staff calculations

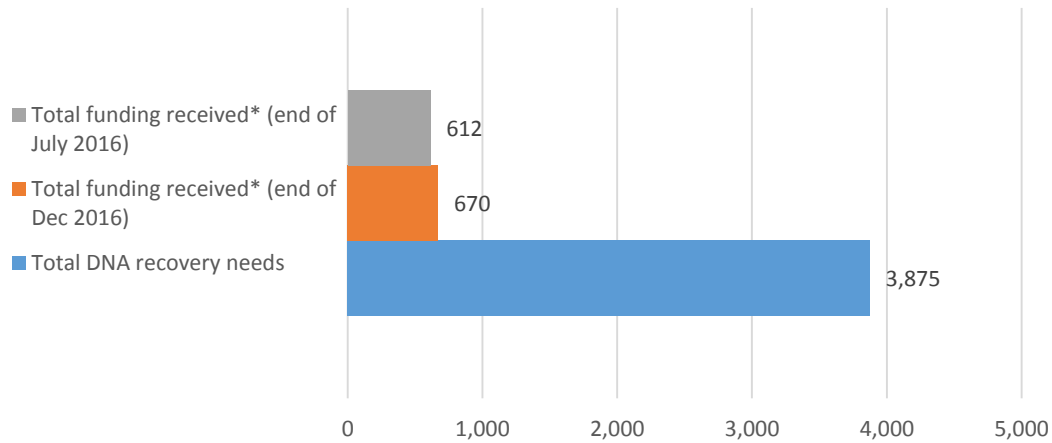
3. **If donor funding continues to be disbursed at the current pace, pledges are estimated to be fully disbursed by the end of 2019; two years behind schedule.** Since the September 2016 AHLC report, disbursements have increased by USD200 million (13 percent). This is consistent with recent periods but extent of delayed funding is growing.

¹⁴ Disbursement figure may change once further data is collected from donors who have not yet provided information about disbursements and allocation of pledges. Support to Gaza figure refers to pledges made at the Cairo Conference and therefore does not reflect all support spent in Gaza after the 2014 war.

¹⁵ The largest seven donors are Qatar, Saudi Arabia, European Union, USA, Kuwait, Turkey and UAE.

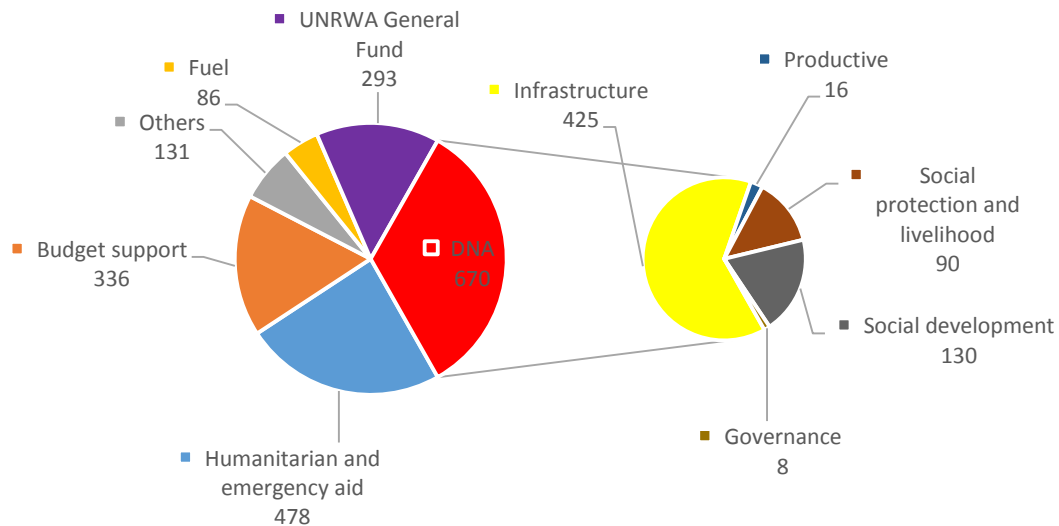
4. **Only 17 percent of the total recovery needs have been addressed as of today.** Out of the USD1.796 billion that has been disbursed, only USD670 million is directly attributed towards priority interventions outlined in the Gaza DNA and Recovery Framework, which covers 17 percent of total recovery needs.¹⁶ When compared to the end of July 2016, the financing of DNA interventions has increased by 9 percent or USD58 million. The infrastructure sector attracted the largest portion of funds with actual disbursements estimated at USD425 million.

Figure 8: Financing of DNA recovery needs from Cairo Conference pledges (USD million)



Source: World Bank staff calculations

Figure 9: Actual disbursements of Cairo Conference support to Gaza by category as of end of December, 2016 (USD million)



Source: World Bank staff calculations

¹⁶ Total recovery needs, identified in the DNA and Recovery Framework, are estimated at USD3.875 billion to cover the economic / human costs of the conflict and finance interventions to help Gaza recover and build back better.

Table 4: Disbursement Status by Donor of Support to Gaza Pledged at Cairo Conference on Palestine "Reconstructing Gaza" in USD Million (End of 2016)

Donor	Support to Gaza	Disbursement of Support to Gaza	Disbursement Ratio of Support to Gaza
Qatar*	1000.00	216.06	22%
Saudi Arabia*	500.00	90.41	18%
European Union¹	348.28	296.73	85%
USA	277.00	277.00	100%
Kuwait*	200.00	48.93	24%
Turkey	200.00	139.48	70%
UAE	200.00	59.08	30%
Norway²	144.98	173.91	120%
European Investment Bank³	70.00	N/A	N/A
Switzerland	65.28	66.96	103%
Germany	63.32	60.67	96%
World Bank	62.00	62.00	100%
Algeria*	61.40	61.40	100%
Japan⁴	61.00	61.00	100%
UK	32.16	32.16	100%
Italy⁵	23.68	4.69	20%
Spain	22.80	14.6	64%
Sudan⁶	20.00	N/A	N/A
The Netherlands	15.31	15.31	100%
Canada	14.66	14.66	100%
Denmark	14.46	14.46	100%
Australia	13.18	13.18	100%
France⁷	10.13	10.13	100%
Sweden	10.00	11.37	114%
Finland	9.31	9.31	100%
Luxembourg	8.97	N/A	N/A
Russia	8.74	8.74	100%
Belgium⁸	7.92	7.92	100%
Bahrain*	6.50	5.15	79%
Austria⁹	5.22	5.22	100%
India	4.00	4.00	100%

Ireland	3.17	3.17	100%
Brazil¹⁰	2.46	2.46	100%
Argentina ^{*11}	2.14	N/A	N/A
South Korea	2.00	2.00	100%
China	1.60	N/A	N/A
Estonia	1.27	0.63	50%
Greece	1.27	0.63	50%
Mexico	1.10	1.10	100%
Indonesia	1.00	N/A	N/A
South Africa	1.00	0.00	0%
Croatia	0.40	0.35	88%
Chile	0.25	0.25	100%
Slovenia	0.190	0.127	67%
Hungary	0.16	0.16	100%
Poland	0.10	0.10	100%
Malaysia	0.10	0.10	100%
Singapore	0.10	0.10	100%
Bulgaria	0.06	0.06	100%
Slovakia	0.05	0.05	100%
Romania	0.05	0.05	100%
Serbia	0.05	0.00	0%
Portugal	0.03	0.03	100%
TOTAL*	3,499	1,796	51%

* The figure of total support to Gaza was slightly revised based on updated information from donors of previous estimates.

¹ European Union contribution includes contribution to UNRWA General Fund pro-rata Gaza for 2014-2015.

² Norway did not specify the allocation of its total support between West Bank and Gaza. The amount to Support Gaza is an estimate. Disbursement ratio of total support reached 55 percent.

³ European Investment Bank contribution is in the form of a loan.

⁴ Japan pledged USD200 million for Palestinian territories. No specific-pledged amount for Gaza reconstruction. So far, about USD199 million was disbursed of which USD61 million for projects in Gaza, 106 for West Bank and Gaza, 28 million for West Bank and 4.2 million for others.

⁵ Italy's contribution includes a soft loan to the Palestinian National Authority of EUR15 million.

⁶ Sudan's contribution is in the form of in kind assistance (100 thousand tons of cement and USD3 million of medical supplies).

⁷ France's contribution includes total aid for Palestinian territories for the year 2014 only.

⁸ Belgium's contribution is its 2014 General Fund contribution to UNRWA.

⁹ Austria's contribution of USD8.8 million is programmed for the benefit- with some minor exceptions- of people living in Gaza.

¹⁰ Brazil's contribution is in the form of In-Kind (6000 tons of rice).

¹¹ Argentina's contribution is in the form of technical assistance agreement to support Gaza which was signed with MOPAD.

* Data provided by UNRWA and/or the Palestinian Authority.