Report No. PID7990

Project Name	Lesotho-Privatization & Regulatory Reform... Project
Region	Africa
Sector	Private Sector Development
Project Number	LSPE58312
Borrower	Government of Lesotho
Implementing Agency	Ministries of Finance, Transport and Telecommunications, and Natural Resources
Date PID Prepared	July 28, 1999
Appraisal Date	October 15, 1999
Board Date	April 30, 2000

1. Country and Sector Background. Privatization Program. Since the Privatization and Private Sector Development Project (Cr. 2162) became effective in December 1995, the Kingdom of Lesotho has embarked on a disinvestment program focused on the food, air, construction, tourism and pharmaceutical industries. The program started slowly, but has gained momentum more recently with five transactions having been completed: the most significant ones being, the privatization of Lesotho Airways and Lesotho Flour Mills. The Project was, however, designed to support the more general process of privatization, and does not provide for any regulatory reform, necessary when addressing issues of greater private sector participation in business and basic infrastructure. The ongoing Project's initial focus has been overtaken by a rapid deterioration in public enterprises key to the provision of essential business and basic infrastructure (banks, telecommunications and utilities). The deterioration of these services and the resulting increase in the fiscal burden have prompted Government to include the major utilities and the banks in the ongoing privatization program, and indeed for them to become the central focus of the program. To support attendant regulatory reform, holding management and privatization programs, Government has requested additional technical assistance in the proposed sister Privatization and Regulatory Reform Project. In the meantime, the ongoing Project has recently been retrofitted involving the streamlining of the privatization procedures to allow for the completion of ten major disinvestments in the food, air, construction, tourism and pharmaceutical industries, and the sale of assets of 20 smaller agricultural operations; while: (a) reallocation funds to stabilize the banking sector and avert a financial crisis through the securing of one bank and the winding -up of another; and (b) promoting the development of indigenous entrepreneurial skills and ownership of private assets through the establishment of an investment fund.

Business Infrastructure. Main issues relating to the banking and telecommunications sectors are as follows: For the banks, key issues in the sector include: (a) the two state-owned banks, Lesotho Bank and LADB, which together comprise two thirds of the sector, are in extreme distress with a negative net worth in flagrant disregard to prudential regulation,

and a hole (total deposits not covered by performing loans) equivalent to four years of revenue in the LHRF. (US$150 million). Only 31% and 20% of total loans of Lesotho Bank and LADB respectively are deemed performing; (b) liquidity shortfalls funded through a Government guaranteed liquidity line to Lesotho Bank; (c) lack of efficient bank supervision and prudential system has jeopardized the whole financial system; (d) the resultant lack of credit availability from the two banks is hindering development of economic activities- in particular SME development - given the dominant position of these banks in the market; and (e) the deleterious effect the distressed banking system has in developing financial instruments that favor local participation in the privatization program and allow broader local ownership of companies.

For the Telecom sector, main issues relating to the telecommunications sector are as follows: (a) LTC, the national monopolistic operator, cannot provide satisfactory services (poor quality at a very expensive price) for both businesses and consumers, including users in rural areas; (b) the teledensity (main lines per 100 inhabitants) is extremely low (0.7 %), substantially below the regional average of 3.4 lines, with 66% of the lines located in Maseru; (c) LTC operates a saturated network with very limited range of services and low productivity (52 lines per employee); LTC's information system is not effective and reliable, and local and nationals calls are highly subsidized by international calls (LTC draws 70% of its revenues by applying high international tariffs, when international traffic represents only 13% of the traffic); (d) the level of liabilities of LTC limits its investment capacity for network expansion.

Basic Infrastructure Issues. The main issue for basic infrastructure services is the lack of the majority of the population to efficient services (low cost and high quality). For the water sector, the issues are: (a) the lack of reliability in the provision of water and the lack of quality of water provided; (b) a very low coverage of the population, hindering economic efficiency; (c) poor operational efficiency as measured by an UFW level of 33% and low employee productivity; and (d) a tariff setting mechanism hindering industrial development with industrial users cross-subsidizing domestic users. For the electricity sector, the main issues are: (a) a very low coverage of the population (only 2% of households); (b) at the transmission and distribution level, operational efficiency as measured by the following indicators: a very high tariff differential of LEC with regional energy distributors ranging from 140% to 225% for indsutrial users, and a very low employee productivity of 18 connections per employee (average ranges between 60 and 160); (c) high barriers to entry, preventing the expansion of a low customer base in particular SMEs; (d) the financial distress of LEC prevents the company to execute the energy master plan designed to accelerate country-wide electrification.

2. Project Objectives. The primary objective of the project is to support Government of Lesotho (GOL) policy of divestiture from key infrastructure sectors which need to be rehabilitated to allow the efficient provision of services that are critical to the emergence of competitive industrial private sector activities. Specific objectives are to: (a) restore business infrastructure services in the financial and telecommunications sectors through inflow of private capital and improve efficiency through introduction of private managerial practices and competition; (b) reform basic infrastructure services such as water and energy sectors in order to expand

the very limited customer base, and offer to the majority of the population efficient (low-cost and high quality) provision of water and electricity services through the strengthening of the existing infrastructure and introduction of private sector participation; (c) design regulatory framework for future development of utilities in particular support capacity building of agencies involved in the process; and (d) establish the multi-sectoral regulatory agency in charge of supervising the liberalization of the telecommunications, utilities sectors, and the Privatization Unit (PU); (d) launch investment vehicles to ensure and promote local participation in privatization program. This Project will complement reforms initiated under the Privatization and Private Sector Development Project (Cr. 2162).

Furthermore, the Project would improve Lesotho's competitiveness by providing assistance to ongoing efforts to improve the enabling environment for private sector development, including initiating reforms to reduce transactions costs, enhance financial sector activities, and expand exports. The Project will directly contribute to meeting the CAS objectives which aim at promoting a broad-based, private sector-led growth of the economy. Private sector involvement in the privatized entities would help restore growth, increase investment, and improve productivity in a number of key economic sectors.

Progress towards these objectives will be measured and monitored through: (a) completion of specific privatization transactions (private sector management or participation in Water and Sewerage Authority of Lesotho (WASA) and Lesotho Electricity Corporation (LEC) inline with the agreed timetable); (b) increased access to all infrastructure services and provision of new services by several private operators in both in the water and electricity sectors; (c) completion of restructuring of WASA and LEC into self-sustainable institutions; (c) improved access to financial services through the licensing of private financial institutions and investment funds, in tandem with enforcement of prudential regulations by efficient regulator; (g) enforcement of a new regulatory framework for telecommunications, water and electricity activities by an independent well functioning multi-sectoral regulator.

3. Rationale for Bank's Involvement. The project will provide technical assistance to: (a) consolidate the government vision and strategy to carry out sectoral reforms in business and basic infrastructure; (b) implement the process of state disinivestment and/or greater private sector participation in these sectors; and (c) set up the necessary regulatory framework to underpin an efficient and transparent shift to greater private sector participation in these sectors. The Bank is uniquely placed to assist Government in the provision of this support given its: (i) international experience in the process of regulatory reform in promoting private sector participation in the telecommunications, water and electricity sectors, and in the setting up of the accompanying legal and institutional regulatory framework; (ii) regional role, particularly through the Southern African Development Community (SADC) in working in concert with other donors to ensure that national reforms in the financial, telecommunications, water and electricity sectors, are in harmony with broader regional objectives; (iii) established close working relationship with the Fund on financial sector issues, whereby this Project and the ongoing IDA-funded Project (Cr. 2162) will complement Fund efforts to strengthen regulation and institutional oversight of the financial sector with operational assistance to secure and then divest from the banks; (iv) international and ongoing Lesotho specific privatization experience.

4. Project Description. This project will complement reforms initiated under the on-going
Privatization and Private Sector Development Project. The project has three main components:
(a) business infrastructure reform (banks, telecommunications); (b) basic infrastructure
reform (electricity, water); (c) establishment of a multi-sector regulator; and (d) establishment of an investment fund.

5. Project Financing. The total project, including contingencies, is estimated at US$17 million equivalent, of which IDA will finance US$13.15 million (77%) equivalent.

6. Project Implementation. A project coordination unit in the Ministry of Finance will oversee: (a) the process of regulatory reform, with the Ministries of Transport and Telecommunications, and Natural Resources being responsible for implementation; (b) the divestiture/private sector participation, with the PU being responsible for implementation.

Overall coordination of the project will be managed by a special unit located in the office of the Minister of Finance. The unit will ensure overall coordination and coherence with sector strategies, in particular those developed with the Ministries of Transport and Telecommunications and Natural Resources, as well as the Central Bank of Lesotho. This unit will be staffed with two persons and will specifically be in charge of. (a) monitoring progress via the performance indicators and organizing supervision missions; (b) supervising the setting up of the financial and accounting organization for each component; (c) monitoring budget preparation; and (d) timely delivery of audits. Disbursements for this unit would transit through the Ministry of Finance special account. Business and basic infrastructure sectors reforms would be implemented by the PU in the Ministry of Finance in charge of privatization/private sector participation, in close collaboration with the Ministries of Transport and Telecommunications, Natural Resources, and the Central Bank of Lesotho. The multi-sectoral regulator capacity building component will be carried out by a coordination team at the Ministry of Finance.

Accounting, Financial Reporting and Auditing Arrangement : (a) a private accounting firm, acceptable to IDA, will be hired to set up the project financial and accounting systems using a system satisfactory to IDA; (b) an accountant will be hired to keep and monitor the projects accounts for each component; (c) project accounts will be audited annually according to international auditing standards by an independent auditor acceptable to IDA; (d) special accounts and all disbursements under SOEs will be audited semi-annually; and (e) the annual audit report will be submitted to IDA within six months of the end of each fiscal year and the semi-annual audit report within three months of each period.

Monitoring and Evaluation Arrangements: Monitoring and evaluation will be guided by Project Design Summary in Annex I and the Implementation Plan through: (a) quarterly progress reports, prepared by the Project Coordinator, of the Overall Coordination Unit of the Minister's of Finance Office; (b) Bank's supervision missions, annual progress review and project mid-term review; and (c) Government will transmit a project implementation completion report, within six months of credit closing to IDA.

7. Project Sustainability. It is expected that the Public Enterprise Sector will be sharply reduced to a core of PEs by the end of the project. It is also expected that the utilities sector will be largely liberalized with several private operators participating in all segments of the market. Therefore, reforms would not easily reversible.

8. Lessons Learned from Past Operations in the Country/Sector. Privatization in Lesotho has been previously supported by one technical assistance Credit (Cr. 2162). The lessons learned from this experience are: (a) ensure that an appropriate institutional framework is in place and preparation of transactions is contracted out as much as possible; (b) ensure effective instruments are in place so that the local private sector participates and develops through the privatization process; (c) ensure availability of resources to finance severance packages to employees to be laid-off in the privatization/restructuring process; (d) increase local (i.e. Basotho) awareness and support for the program through an effective communication strategy; (e) increase investor confidence through the establishment of improved and more transparent procedures, clearly delineating the roles of political and technical decision makers in the privatization process; (f) establish a clear vision for the privatization process so that the program's impact on resolving country growth constraints is maximized; (g) minimize restrictions on investor qualifications to maximize competition and local participation in the program; and (h) streamline procedures for relatively small disinvestment transactions.

9. Poverty Impact. The Project would have a positive impact in alleviating poverty, as it would directly benefit both urban and rural populations as the Project will contribute to broad private sector-led growth and job creation in the country by maintaining and enhancing a business environment that promotes the competitiveness of the private sector. Lesotho has witnessed impressive growth in labor intensive industry in the last eight years, with job creation outstripping original targets (Bank funded Cr.2195, supporting the closed (June 30, 1998) Industrial and Agro-Industries Project witnessed the creation of 8,200 new jobs in the garment-assembly industry over a target of 3,500). To maintain this impressive achievement, the financial sector needs to be stabilized and basic telecommunication services need to be restored. To enhance private sector competitiveness and sustain a shift from "footloose" to more permanent industrialization, greater access to quality cost competitive business and basic infrastructure services needs to be developed. The importance of developing domestic industrial job expansion is becoming more and more pressing, given the ongoing decline of jobs in the South African mining industry and the consequent return to Lesotho of migrant labor. The Project would help alleviate the hardship resulting from layoffs under the retrenchment program..

The Project will, furthermore, promote the provision of piped water to an increasing number of people through private sector participation (PSP) and management of the existing distressed operator, and through increased competition in the sector. Increased access to electrical energy by a larger proportion of the population - through PSP - will also result in savings from the substitution of electricity in end-users, which typically currently depend on kerosene, candles, and batteries, and will make possible increased economic activity.

10. Environment Aspects (including any public consultation). The project,

being technical assistance in nature, is not expected to have a direct major environmental impact. Measures implemented as a result of regulatory reform and the disinvestment process from utilities may, however, have a minor impact on the environment. An environment impact study will, therefore, form part of the divestiture process for the three main utilities.

11. Program Objective Category. The project supports IDA's private sector development and economic management objectives.

12. Contact Points:

Neil Simon M. Gray (Task Manager)
The World Bank
1818 H Street,
NW Washington D.C. 20433
Telephone: (202) 473 - 4011

The InfoShop
The World Bank
1818 H Street, N.W.
Washington D.C. 20433
Telephone: (202) 458-5454
Fax: (202) 522-1500

Processed by the InfoShop week ending July 30, 1999.

Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.