Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No. 20581

PERFORMANCE AUDIT REPORT

PHILIPPINES

RURAL ELECTRIFICATION REVITALIZATION PROJECT (LOAN 3439-PH)

June 15, 2000

Sector and Thematic Evaluations Group
Operations Evaluation Department

Currency Equivalents (annual averages)

Currency Unit = Philippine Peso (P)

1993	*US$1.00*	*P27.12*
1994	*US$1.00*	*P26.42*
1995	*US$1.00*	*P25.71*
1996	*US$1.00*	*P26.22*
1997	*US$1.00*	*P29.47*
1998	*US$1.00*	*P40.89*
1999	*US$1.00*	*P39.06*

Weights and Measures

kWh	Kilowatt-hour (1,000 watt-hours)
MW	Megawatt (1,000 kilowatts)
GWh	Gigawatt-hours (million kilowatt-hours)

Fiscal Year

Government: January 1–December 31

Abbreviations and Acronyms

ADB	Asian Development Bank
DOE	Department of Energy
ERB	Energy Regulatory Board
GOP	Government of the Philippines
IBRD	International Bank for Reconstruction and Development
IPP	Independent power producer
NEA	National Electrification Administration
NPC	National Power Corporation
OECF	Overseas Economic Cooperation Fund
OED	Operations Evaluation Department
PAR	Performance Audit Report
PIP	Performance Improvement Program
REC	Rural electricity cooperative
RERP	Rural Electrification Revitalization Project
SAR	Staff Appraisal Report
SOP	Statement of Operating Policy
USAID	United States Agency for International Development

Director-General, Operations Evaluation	:	Mr. Robert Picciotto
Director, Operations Evaluation Department	:	Mr. Gregory Ingram
Acting Manager, Sector and Thematic Evaluations	:	Mr. Ridley Nelson
Task Manager	:	Mr. Fernando Manibog

FOR OFFICIAL USE ONLY

The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

June 15, 2000

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Report on Philippines Rural Electrification Revitalization Project (Loan 3439-PH)

Attached is the Performance Audit Report (PAR) prepared by the Operations Evaluation Department (OED) on the above project, which was supported by a loan of US$91.3 million to the National Electrification Administration (NEA). The loan was approved in fiscal 1992 and closed in April 1998, 16 months behind schedule. A total of US$36.7 million was canceled.

The objectives of the project were to (a) enhance NEA's capability to function as an effective core agency for rural electrification, (b) improve the performance of the rural electrification cooperatives, and (c) increase the availability and reliability of electricity supply in rural areas by financing part of NEA's 1992–95 investment program.

Project outcome is rated unsatisfactory because the physical and institutional benefits directly attributable to the project were both substantially less than projected at appraisal and seriously delayed. The institutional development impact of the project is rated as modest in light of improved rural electricity cooperative performance and better NEA monitoring practices. Sustainability of the project benefits is rated uncertain due to NEA's financial problems, which remain unresolved. These ratings do not differ from those in the ICR. Bank and borrower performance are both rated unsatisfactory.

The main lessons from this project are:

- Critical policy reforms requiring legislative action should be passed before a Bank loan is approved by the Board
- Midterm reviews of projects provide a useful opportunity to rectify problems not anticipated at appraisal and should be undertaken systematically.
- Bank reluctance to use remedies at its disposal when borrower performance is unsatisfactory can be counterproductive to achieving project goals.
- Lending directly to rural electrification umbrella agencies on IBRD terms for rural electrification projects is hard to justify except in the case of financially very strong entities.

Attachment

Contents

This report was prepared by Fernando Manibog (Task Manager) and Sunil Mathrani (Consultant), who audited the project in October and November, 1999. William B. Hurlbut edited the report. Marie Daramy provided administrative support.

Principal Ratings

	Audit	*ICR*
Outcome	Unsatisfactory	Unsatisfactory
Sustainability	Uncertain	Uncertain
Institutional Development	Modest	Partial
Bank Performance	Unsatisfactory	Highly Unsatisfactory
Borrower Performance	Unsatisfactory	Unsatisfactory

Key Staff Responsible

	Task Manager	*Division Chief*	*Country Director*
Appraisal	J. Sopher	I. Sud	G. Kaji
Midterm	J. Sopher	J. Shivakumar	C. Madavo
Completion	H. Pape	Y. Sumi	V. Bhargava

Preface

This is a Performance Audit Report (PAR) on the Philippines Rural Electrification Revitalization Project for which the Bank approved a loan (3439-PH) of US$91.3 million on February 25, 1992. The original closing date of December 31, 1996, was extended until April 30, 1998. A total undisbursed balance of US$36.7 million was canceled.

This report was prepared by the Operations Evaluation Department (OED) based on the Implementation Completion Report (ICR) prepared by the East Asia and Pacific Region, issued on January 15, 1999, the Staff Appraisal Report, loan documents, project files, and discussions with Bank staff. An OED mission visited the Philippines in October 1999 to discuss the effectiveness of the Bank's assistance with the government and the National Electrification Administration (NEA), the project implementing agency. The collaboration and assistance of government officials, NEA, and the management and staff of the electricity cooperatives are gratefully acknowledged.

Following standard OED procedures, the draft of this PAR was sent to the borrower for comments before finalization. Comments received from the Borrower are included as Annex B.

1. Background

1.1 The democratic government that came to power in the Philippines in 1986 inherited deep-seated economic and political crises that left a lasting impact on the country. To this day, the country is saddled with a high burden of public debt, a third of households live below the poverty line, and income distribution is heavily skewed. The excesses associated with the Marcos regime (1967–86) produced a consensus within the country that the path to economic recovery should remain genuinely democratic and participatory. The devolution of fiscal resources and responsibilities to local government units since 1991 has been enthusiastically embraced at the local level as a means of further decentralization of economic and political power.[1]

1.2 Electricity distribution in the Philippines has been decentralized since the early 1970s. Today, the 119 rural electrification cooperatives (RECs), with over 4.7 million customers, account for over half of all electricity consumers in the Philippines but only about 20% of electricity consumption. Within the geographical areas covered by the RECs, nearly 40% of households still do not have access to electricity.[2] The RECs are misleadingly named because in reality they serve many large urban areas (outside the four main cities) and provincial towns in addition to rural areas. The RECs are a very diverse group: the largest has more than 100,000 residential consumers and the smallest not even a thousand.

1.3 In 1988, as part of its efforts to support the new government's economic recovery program, the Bank conducted a major review of the energy sector.[3] That review provided the initial framework for nine Bank energy projects between 1988 and 1996, more than in any other sector at that time. The power sector, in particular, was the focus of both lending and sector work. Substantial staff resources were devoted to comprehensive analyses of structural and financial issues[4] that needed to be addressed as a prelude to greater private sector involvement. Unfortunately, despite their relevance and valuable contribution to the general understanding of the complex issues in the power sector, the Bank's sector work did not prevent its own portfolio of power projects from running into serious implementation difficulties during the mid-1990s.

1.4 The Bank ceased to lend for rural electrification, after an initial project with the National Electrification Administration (NEA), which was completed in 1983. A small rural electrification component of the wide-ranging 1989 Energy Sector Project[5] was implemented by NEA, but prior to a more substantial involvement in rural electrification by the Bank, detailed sector work had to be undertaken. Rural electrification sectoral issues were therefore examined in detail in a separate Bank study in 1989[6] (para 7). This laid the foundation for the Rural Electrification Revitalization project, (RERP), the subject of this audit.

1.5 Until the early 1980s, the rural electrification program in the Philippines was well funded by foreign aid and concentrated on rapidly increasing the number of household connections without due

1. From paragraphs 2-3, Philippines CAS, 02/96, Report No. 15362-PH.

2. At the national level, 75% of all households are electrified because of the near-100% access rate within the Manila metropolitan area.

3. Philippines Energy Sector Study, Report No. 7269-PH, September 1988.

4. Structural Framework for the Power Sector, Report No. 13313-PH, November 1994.

5. Loans 3163, 3164 & 3165-PH for which PAR No. 17651 was issued in April 1998.

6. Rural Electrification Sector Study: An Integrated Program to Revitalize the Sector, Report No. 8016-PH, November 1989.

concern for cost or economic viability. The highest annual increase in new connections took place in 1980 when more than 320,000 new consumers were added. However, from 1983 onward, foreign funding dried up and the rural electrification program shrank dramatically. In 1988, the number of new connections had fallen below 100,000, its lowest level for 15 years. The rural electrification sector faced a serious financial crisis because it was unable to cover its operating expenses from consumer revenues. When external donor funding ceased the problems became apparent: the consequences of NEA lending to RECs at below market rates; its failed investments in alternative generation schemes; the neglect of maintenance by the RECs and their small, high-cost, low-demand networks; low tariffs; poor revenue collections; and their difficulties in meeting debt service to NEA. GOP's rural electrification program had serious financial and institutional weaknesses that jeopardized its long-term viability, but which had been masked by the inflow of funds for new capital projects. By 1989, only 22 of 120 RECs were financially viable and NEA's collection efficiency was only 36%. Total energy distribution losses averaged 25%. Household access to electricity in areas served by the RECs had still only reached 50% by 1990.

2. Project Objectives, Design, and Quality at Entry

2.1 According to the Staff Appraisal Report (SAR), the Rural Electrification Revitalization Project sought to:

- Enhance NEA's capability to function as an effective core agency for rural electrification
- Improve the performance of the rural electrification cooperatives through operational and financial reforms
- Increase the availability and reliability of electricity supply in rural areas by financing part of NEA's 1992–95 investment program.

2.2 The project's objectives were highly relevant. They were formulated from the analysis carried out under the Rural Electrification Study, which was a thorough piece of sector work and which had been discussed with the interested parties in the Philippines during 1989/90, in order to build a consensus on the sectoral reform approach to be followed. However, it is noteworthy that the project contained no quantified objective for expanding access to electricity in rural areas, despite GOP's declared intent to electrify 90% of barangays by 1995.[7]

2.3 The Rural Electrification Study had concluded that the pervasive nature of the problems in the rural electrification sector necessitated an integrated program of reforms that would improve the operational efficiency of the RECs, introduce sound pricing principles, a viable investment strategy, and restructure NEA and the RECs. It correctly emphasized the importance of rehabilitating the existing REC networks in order to improve service to existing consumers and to permit adding new, 'in-fill' connections to the network. Extending supply to unserved areas was judged to be of low priority, particularly as many RECs suffered from the consequences of earlier socio-political decisions to electrify unviable areas.

2.4 The project had a long gestation period of two years from completion of the Rural Electrification Sector Study to loan negotiations and was thoroughly prepared in most respects. The integrated program of reforms for sector revitalization that emerged from the Rural Electrification Study provided the policy underpinnings for the project. These reforms had the support of the key players in the sector and, prior to

7. The same target was to have been achieved by 1987. It is now the target for 2004.

Board approval of the Loan, NEA had already adopted a new Statement of Operating Policy governing its lending to RECs and a new electricity pricing formula to encourage self-financing of investments by the RECs. GOP had also agreed to a financial restructuring plan to ease NEA's debt burden. All of these were propitious signs for the successful implementation of the project. However, the design of the project had a crucial shortcoming that later proved to be a major contributor to the project's implementation problems and eventual failure.

Assessment of Implementation Capacity

2.5 As pointed out by the ICR, the appraisal team over-estimated NEA's project implementation capabilities and did not institute any project-specific implementation arrangements within NEA. This is surprising, given that NEA's investment program in the mid-1980s was small and the previous Bank project had ended in 1983, with the result that NEA would not have undertaken major international procurement in the period immediately preceding the project. The RERP was relatively large, involving about 50 RECs, yet the Bank's appraisal team felt it could be implemented in under five years *without* a Project Implementation Unit (PIU). This proved not to be the case. An effective PIU could have avoided or mitigated the many procurement problems encountered during the project (which have been amply treated in the ICR and are not re-examined in this audit). A PIU might also have helped to insulate the project from the debilitating effect of the replacement of NEA's entire top management in early 1993.

Assessment of Project Risks

2.6 The assessment of risks in the SAR was weak in several areas. It acknowledges that the project might encounter implementation delays due to its ambitious nature, while claiming that 'at appraisal the Bank tried vigilantly to ensure that the proposed project would not exceed the absorption capacities of NEA and the participating RECs." This proved to be far too optimistic an assessment and the appraisal did not correctly perceive the limits to NEA's capabilities or incorporate a PIU to overcome the absorptive capacity constraint.

2.7 Second, the risk to NEA's financial restructuring from a failure by congress to pass the necessary enabling legislation is not even mentioned in the SAR. Yet the financial restructuring was crucial to putting NEA's finances on a sound footing. It was also a prerequisite for justifying the direct IBRD loan to NEA, with the latter bearing the foreign exchange risk. At the project preparation stage, Bank staff had indicated that governmental action on the bailout of NEA would be required even before appraisal, but at each important processing milestone the up-front action expected of GOP was waived by the Bank. The risk of further inaction was clearly high and since the timing of congressional approval was not within GOP's control, this risk should have been highlighted in the SAR. In the end, the financial restructuring never took place due to congressional inaction, with the undesirable result that the IBRD loan has aggravated NEA's already weak financial situation. Experience in both the Philippines and elsewhere has repeatedly shown that it is unwise to link the implementation of a project to the passage of a law.

2.8 Thirdly, the RERP did not tackle the issue of NEA's reporting relationship to GOP and its politicization. At the time of appraisal NEA reported to the Department of Environment and Natural Resources, while the other sector entities were attached to the Office of Energy Affairs in the Presidency. Prior to 1986 NEA had been under the former Ministry of Human Settlements. The RE Study correctly identified the drawbacks of having NEA report to socio-political rather than technical branches of GOP. It had led to a lack of clarity as regards its role in the energy sector, and a tendency to use it for broader rural development objectives unrelated to the provision of electricity. This issue was not addressed in

RERP's design. Fortunately, in the energy sector reorganization of 1992 which led to the creation of the Department of Energy, GOP acted upon the matter and consolidated all energy entities under DOE.

3. Project Implementation

3.1 During the six years of implementation (1992–98), the project made only modest progress on attaining its objectives. The physical investments it was to finance were seriously delayed and executed only partially. Non-procurement of poles and conductors meant that RERP made a minimal contribution to providing electricity to new consumers, while the SAR had expected 300,000 new consumers to be hooked up as a result of the project. The project's impact in strengthening NEA has been minor. There has been significant progress in overall REC performance, but it is hard to assess to what extent the project directly contributed to this objective because of the interplay of a multiplicity of factors that all had an impact on RECs. The ICR states that the materials funded by the project assisted the RECs in reducing their energy losses and in improving the quality of supply, but was unable to quantify this benefit.

3.2 The project had a promising start. Some of the reforms recommended by the sector study were implemented before Board approval of the loan, partly as a result of Bank conditionality. NEA had raised its lending rates to the RECs, improved its collections and its oversight of the RECs. The adoption by NEA's Board of a new Statement of Operating Policy (SOP), before loan negotiations was an indication of GOP commitment to pursue the new approach in the sector. The SOP shed NEA's peripheral activities to promote broader rural development and formalized NEA's role as an 'interested' lender. As such, NEA staff had taken over the management of many of the weakest co-ops and virtually all the RECs had substantially raised their tariffs. System losses had fallen to 21% by the time the loan was approved by the Board. Onlending by NEA was subject to the agreement by the borrowing REC on a performance improvement plan (PIP). NEA's investment guidelines required it to lend only for projects with a rate of return of 15% or more.

3.3 Unfortunately, within six months of loan effectiveness, the top management team at NEA was replaced. These individuals had worked very closely with the Bank's project staff over the previous three years in designing and preparing the sector reforms and the NEA recovery program. This change was a severe blow to the project because the skills, experience, and commitment of these managers would have greatly aided project implementation. A long period of indecision then prevailed in NEA while the new management settled in, with the result that the RERP was stalled. Bank staff, meanwhile, turned their attention to other pressing problems in the electricity sector[8] and reduced their intensive supervision efforts. They also do not appear to have succeeded in establishing a close collaborative working relationship with the new NEA management, who also did not share with their predecessors the same level of commitment to project success. The audit was unable to ascertain the reasons for these attitudinal problems and difficulties in inter-personal relationships, even though it is clear that they had a profoundly adverse impact on the project.

3.4 By late 1993, 18 months after Board approval, it was apparent to the Bank that the RERP was in serious difficulty, but the internal Bank supervision ratings were not downgraded to reflect this. The Bank apparently considered undertaking a reappraisal in early 1994, but this did not occur, probably because of the preoccupation of the Philippines energy team with National Power Commission (NPC) problems. Meanwhile, USAID, which had been providing parallel financing to the project, decided to phase out its

8. Such as NPC's financial problems, its unbundling and structural reform of the power sector as a whole.

involvement in the sector, which added to the implementation problems because USAID had been providing useful technical assistance to NEA, some of which related to strengthening procurement capacity. A midterm review of the project that was intended for mid-1994 also did not take place, probably due to staff constraints following the sudden death of one of the key members of the Bank's team responsible for the Philippines energy sector. Such a review would have provided the Bank with a more thorough picture of the implementation problems within NEA and could have led to the setting up of a strong PIU. Alternatively, it would have given the Bank's management an opportunity to consider more fundamental changes or remedies such as loan suspension or even cancellation in the face of unsatisfactory performance.[9]

3.5 By mid-1995, more than three years after Board approval of the project, procurement issues were proving intractable and under US$2 million had been disbursed out of the US$91 million Bank loan. The NEA capitalization bill had failed for the second time to receive senate approval before the end of the congressional session. In the words of the supervision mission aide-memoire,[10] "the project faces too many problems" for the aide-memoire to even prescribe measures that the borrower needs to undertake. Despite this, and its classification as a "problem project" Bank management did not issue any loan suspension warning to NEA. Nor were supervision efforts intensified because the Philippines energy team continued to prioritize new lending to NPC.[11]

3.6 A year later, and just 6 months before the original closing date, some of the procurement issues had been resolved and a substantial portion of the loan amount had been firmly committed. As a result, the project was reclassified as satisfactory[12] and the closing date extended by a year. Although it was clear that this would not suffice to complete the project, the Bank's task manager was unwilling to endorse the NEA request for a two-year extension.

3.7 As the extended closing date approached, the project was plunged into controversy and received unfavorable media coverage arising from a congressional investigation into alleged procurement irregularities. A new Bank task manager took over at this stage. Procurement had slipped from the schedule that was the basis for the original loan extension and, astonishingly at such a late stage in the project, deliveries of poles and conductors crucial for line extensions had not even begun. At this point, it became apparent that most subprojects for which the Bank-funded materials were intended had meanwhile been implemented by the RECs using other resources.[13] Consequently, other subprojects have had to be found for the materials procured for RERP.

3.8 In order to keep up pressure on NEA, and conscious of the likely management changes following the presidential elections in May 1998 that would inevitably lead to more delays, the Bank decided to extend the loan by only four months, with the offer of a further short extension if NEA provided a plan for the reallocation of the Bank-funded materials to new subprojects. This revised allocation schedule was not satisfactory and the loan was closed, even though this meant that NEA would be left without financing amounting to about US$12 million for ongoing contracts that had already been partially funded by the Bank Loan. Bank staff appear to have lost all patience with NEA by this stage and management was also

9. The project was given an unsatisfactory rating for the first time in mid-1994.

10. Dated 13 June 1995, paragraph 11.

11. The Transmission Grid Reinforcement Project (Ln 3996-PH) was appraised in June 1995.

12. This upgrading was based on undue optimism rather than substantive progress, as later events revealed.

13. The stronger RECs finance a growing share of their investments from a mix of internal cash generation, GOP/Congressional funds and local (non-NEA) borrowing.

keen to rid itself of this problem project. The option of extending the loan to cover disbursements only for ongoing contracts does not appear to have been considered.

3.9 A new administrator was appointed to run NEA in mid-1998 and was faced with the unenviable tasks of arranging alternative financing from GOP to cover NEA's obligations to suppliers under the outstanding Bank contracts and also with persuading reluctant RECs to draw upon Bank-funded materials in NEA's stores which they no longer wished to use in the short-term.[14] NEA's financial problems are compounded by the fact that it has to service the debt to IBRD incurred to acquire these materials, but which will bring it no income until it signs onlending agreements with RECs for their use. Despite an appeal from the new administrator, the Bank declined to reconsider its decision not to extend the loan, 40% of which remained undisbursed at closure.

4. Key Issues

NEA's Financial Difficulties

4.10 Despite repeated attempts during nearly a decade, the Philippines congress failed to pass the necessary enabling legislation required to recapitalize NEA, write off its unrecoverable loans, and restructure its balance sheet. This reflects poorly on all concerned parties: GOP for not ensuring that the NEA bill received adequate support and congressional time, NEA and the RECs for lobbying insufficiently to support legislative passage, congress itself for its lack of concern for an agency whose work is supposedly a national priority, and finally the Bank for continuing to increase its exposure[15] to an uncreditworthy borrower. The SAR for the project pointed out that NEA was insolvent. This remains true today. Despite receiving a subsidy from GOP of PHP 500 million in the form of payment of interest on its debts, NEA made a net loss of PHP 202 million in 1998. Even after this GOP subsidy, NEA's internal cash generation was insufficient to cover its debt service. Furthermore, its balance sheet, if adjusted to comply with international accounting standards, would show negative net worth and negative working capital. It has been a burden on public finances for the past 15 years, even if the scale of its financial problems are dwarfed by those of other state enterprises such as NPC. The bill to increase NEA's capitalization was filed with the new Congress in 1998. The House Energy Committee approved this bill on March 22, 2000 and it is now on the way to floor deliberations.

REC Performance

4.11 Despite the poor performance of NEA as the REC's procurement agent for distribution materials under RERP, most RECs recorded progress in their operational efficiency during the 1990s. The ICR does not present an adequate picture of improved sectoral performance achieved despite the shortcomings of RERP. In recent years, REC managers have become more cost-conscious and commercially minded as a result of external pressure. Monitoring of REC performance by NEA's Accounts Management Department was a contributory factor. The department was set up in 1993 as part of the RERP measures to strengthen NEA and to monitor the PIPs, which were also instituted as part of the project. But as the

14. However, GOP's emphasis on expanding access to electricity in rural areas should result in these materials being used in the coming years.

15. The Bank is NEA's largest lender, accounting for about 20% of its foreign debt.

ICR rightly points out, NEA does little to enforce compliance, despite its considerable statutory powers to replace managers, dissolve Boards, and withdraw the franchise license of poorly performing RECs.

4.12 NEA also administers a performance rating system for the RECs based on a range of quantitative criteria that shows a steady rise in the number of RECs classified as A or A+ performers. In 1988, only 18% of RECs received the top rating. Ten years later this had risen to 60%. These RECs do not need to have their operating budgets approved by NEA and most would be creditworthy to borrow from local banks. Several of the strongest have little need of NEA and chafe at what they see as its excessive powers to interfere.

4.13 Progress by RECs in energy loss reduction has been significant: the average systems loss fell from 24% in 1988 to 17% ten years later. Nearly 40% of RECs achieved even better results with losses below 14%. However performance is very diverse and nearly a third of RECs had losses exceeding 18%. Transformers and substations built as part of RERP contributed to reducing technical losses. Progress in loss reduction has also been assisted by the 1994 Anti-Pilferage Act, which imposed a declining cap on system losses allowable in tariff setting. The cap has been set at 14% for 2000, which is likely to prove a tough target to meet.

4.14 The RECs have had less success in improving revenue collection, which now stands at 91%, slightly below the peak of 93% achieved in 1992–94. Nevertheless, over 70% of RECs now have a collection efficiency above 90%. Their repayment performance to NEA has shown dramatic improvement from about 50% ten years ago to 93% in 1998. On the other hand, 28% of RECs continue to have overdue accounts for their power purchases from NPC and almost 40% of RECs registered net financial losses in 1998, despite very substantial tariff increases during the 1990s.

Future Prospects for RECs

4.15 The electricity distribution sector has improved its performance during the 1990s, but still has many problems to overcome, few of which have easy solutions. Consumer awareness, regulatory pressure, and competition will help to gradually impose better technical and financial management, but efficiency will continue to be constrained by size, geography, and institutional factors.

4.16 For many years the Bank has argued that electricity distribution in the Philippines is excessively fragmented and that consolidating RECs would optimize supply and increase efficiency. In practice, only one merger has occurred among RECs over the past decade and only one is currently under active consideration. Local opposition is understandable because of the ensuing loss of privileges for managers and board members as well as the fear of job losses among employees. Consumers' interest in better, cheaper service is subordinated to these vested interests. However, pressure from ERB on tariffs and the looming threat of competition in supply to large consumers mean that more mergers may be considered. But given the cooperative status of RECs, it would be extremely difficult politically for GOP or NEA to impose consolidation among RECs. Civil society would need to be extensively consulted and implicated in such steps. Even without mergers, greater financial transparency and better governance at the municipal and REC level would automatically lead to a better deal for electricity consumers as they would make collusive practices more difficult.

Extending Access to Electricity

4.17 During the early 1990s, due to other sectoral preoccupations, expanding access to electricity was not a high priority for GOP, despite a long-standing political commitment to it. However, in the second half of the 1990s, the annual increase in the number of new connections once again rose to well above 200,000, levels not achieved since the heyday of the early 1980s. At first sight this is surprising in the face of the delays and difficulties in implementing RERP and the parallel, Japanese-funded project.[16] Since the annual average flow of investment funds[17] from NEA to the RECs between 1996 and 1998 was less than P800 million (US$20 million), clearly the RECs had access to substantial non-NEA resources, such as local bank borrowing, internal cash generation, GOP monies channeled to local government units for rural infrastructure and the use of congressional budgetary funds. Since 1992 when the tariff setting formula was revised to include a provision for reinvestment amounting to 5% of gross revenues, many RECs have been able to make a significant internal contribution to their investment programs. In 1998, available data indicates that the 120 RECs together invested about P2.8 billion (US$69 million), of which only about P380 million, or about 13%, was provided by NEA in the form of loans or grants.

4.18 GOP's medium-term development plan 1999–04 has set an ambitious target for the RECs of 82%[18] household electrification by the end of the period, up from about 63% today. This would require an average of 0.3 million new connections annually for the six-year period, which has been achieved in the past, but not for a sustained 6-year period.

4.19 The plan estimates the cost of achieving these targets would be nearly US$600 million in constant prices, which appears to be low. Furthermore, the bulk of the funds would have to come from public sources. GOP has never invested such large sums in the rural electrification program in the past. Nor is it apparent that public resources would be available on this scale in the future to fund the program.

4.20 It is also questionable whether raising electricity access levels to such a high percentage is a critical priority in alleviating rural poverty, an important theme of both GOP and the Bank's assistance strategy. In the absence of other crucial rural infrastructure, providing grid-supplied electricity at costs well in excess of US$0.25 per kilowatt-hour will do little to raise productivity and living standards. The cost of increasing access to grid electricity rises as more and more remote or sparsely populated areas have to be served. The 1989 Rural Electrification Study estimated that it would be economic to serve about 70% of the rural population, but that even in the long-term, covering more than 75% of the population would be hard to justify economically. Furthermore, the growing pressure on the RECs to improve their operational efficiency makes extension of supply to new areas even more unattractive from a financial point of view. Alternatives to grid extension need to be given more emphasis as a part of a package of essential rural infrastructural needs in the provinces where the incidence of poverty is highest.

16. OECF made an untied loan of ¥10 billion loan to NEA in 1994. This project is still under implementation.

17. Loans and subsidies together. The latter accounted for about a third of total disbursements.

18. This would be comparable to the level of rural electrification achieved by Thailand in the mid-1990s.

5. Bank and Borrower Performance

Bank Performance

5.1 The lapses, weaknesses and inconsistencies in the Bank's performance before and after the loan became effective are striking. On the one hand, the prior sector work was of a very high quality, significant staff resources were used to bring the project to the Board, and the Bank initially had a strong team with a good skills mix. The findings of the sector work, however, are not adequately incorporated into the final project design, particularly the enormous weaknesses of the rural electricity subsector that should have served as a warning for the Bank not to underestimate the project's risks and difficulties ahead. One of the critical shortcomings that this audit found was the lack of a PIU in the initial project design and the decision to proceed with the loan even in the absence of congressional approval for NEA's financial restructuring. Another one is the absence of good monitoring indicators on project performance. Many important milestones consisting of upfront actions were waived or postponed by the Bank, which indicates a pressure to lend despite the likelihood of implementation problems.[19] The overall environment for project implementation was highly political, yet the project was presented to the Board just before the elections, which laid the ground for staff intability in NEA. Once implementation began, the Bank's performance slumped even more badly, as explained below. Consequently, this audit assesses overall Bank performance to have been highly unsatisfactory.

5.2 Supervision of RERP was inadequate from mid-1993 onwards as staff were diverted to processing of other large projects with NPC and dealing with its financial problems. The Bank's Philippines energy team was also depleted due to transfers and a death and there were long lags before replacements took over. In mid-1994 when there were **seven** energy projects under implementation, and when the RERP was in great need of restructuring and/or a thorough midterm review, Bank staff seem to have been overwhelmed by the volume, range and complexity of the issues they had to deal with in the portfolio. In spite of the serious procurement problems and NEA staff instability, little time was spent on supervising RERP, albeit additional efforts were made by the operations officer in Manila responsible for energy and transport operations. The critical four-year period of 1993-1997 had only five supervision missions in the field, of which four had only one Bank staff member, i.e., a financial analyst in three of these four visits. At times, as little as only 2 days were spent on supervision. Yet at the same time, substantial staff resources were deployed on producing a major study of institutional reform of the power sector.[20]

5.3 In this context, RERP was apparently bottom on the list of the Bank's priorities in the sector. The Bank failed to undertake a midterm review of RERP in 1994 and thus lost a suitable occasion to either take corrective action or cancel the loan before major financial commitments were made against it by NEA. Despite the increased emphasis of the Bank's senior management on the quality of the project portfolio and the increased importance attached to supervision, the Region did little in the course of the next two years to improve the quantity[21] or quality of its supervision at the NEA level or engage GOP in a dialog on the stalemate regarding the NEA financial restructuring. The mid-1996 restoration of the

---

19. The Bank staff and management took a calculated risk by proceeding with the project in good faith even before full passage of the bill. Unfortunately, the bill was blocked by two senators and could not be enacted into law.

20. Philippines Power Sector Study, Structural Framework for the Power sector, November 1994, Report No. 13313-PH.

21. According to the ICR Table 13, there were only 3 supervision missions (8/94, 6/95 and 5/96) and they consisted of one person for one week only.

satisfactory performance ratings and the recommended extension of the loan's closing date by the Philippines energy team also gave Regional Management a wrong signal of progress in implementing RERP.

5.4 Finally, in an attempt to mitigate its belated recognition of the intractable nature of the problems facing RERP, the Bank took a set of ill-considered decisions in late 1997 that were not in the best interests of the borrower. The Bank had been lax in enforcing compliance with loan covenants during most of the project's life and had ample time to cancel all or part of the loan at a point where the consequences would have been less disruptive. It then abruptly became insensitive to NEA's point of view at a critical juncture in the project, granted an inappropriately short loan extension (four months) which did not permit the implementing agency to even complete payments under ongoing contracts. Bank management should have known from experience that arbitrarily short extensions in situations where implementation lags are much longer prevents project restructuring or reprogramming that a single, longer loan extension would allow. Nor did the Bank provide a sufficiently early warning to NEA that it would only grant such a short final extension. Hardly surprisingly, the Bank's relations with NEA have soured as a result of the decision to close the project in this hasty manner.

5.5 This audit considers that the Bank abdicated responsibility for the project's problems and left NEA and GOP with a foreign currency loan that financed virtually no productive investments capable of generating the revenues necessary to service this debt.

Borrower Performance

5.6 Just as for the Bank, NEA's performance was satisfactory up to the time of physical implementation of RERP. Preparation was carried out well and NEA appeared to have embraced the reform approach advocated in the Rural Electrification Study. Up-front action to implement its recommendations prior to loan approval demonstrated an adequate degree of ownership by the borrower. Unfortunately, subsequent borrower performance throughout its implementation was highly unsatisfactory, as indicated by the ICR. For this reason, overall borrower performance is rated as unsatisfactory.

5.7 The NEA management team who took over responsibility for the project for the five years before its closure never demonstrated adequate commitment to its success or a readiness to seek solutions to expedite it. NEA's poor management of procurement was a serious disservice to its clients, the RECs, many of whom had commitments to their own members for projects they were unable to implement because of the lack of materials that NEA was to procure on their behalf. Understandably they made other arrangements to obtain their supplies elsewhere and today they are reluctant to draw on the very delayed Bank-funded materials. The abrupt termination of the project and the unfinished business that still remains to be dealt with (paragraphs 3.8 and 3.9) has hurt NEA's image in both the eyes of its borrowers as well as its lenders.

5.8 NEA and GOP were both remiss in not actively seeking congressional approval for the NEA financial restructuring that was the basis for the direct IBRD loan to NEA, which was and is still uncreditworthy for such loans. NEA appears to have been content to continue with its old practice of leaving GOP to meet its foreign debt service obligations.

Overall Project Assessment and Ratings

5.9 The overall project outcome is rated as unsatisfactory because the physical and institutional benefits directly attributable to the project were both substantially less than projected at appraisal and seriously delayed. The overall institutional development impact of the project is rated as modest in light of improved REC performance and better NEA monitoring practices. Sustainability of the project benefits is rated as uncertain due to NEA's financial problems, which remain unresolved. These ratings do not differ from those in the ICR.

6. Lessons Learned

6.1 The following lessons can be drawn from this project:

- Critical policy reforms requiring legislative action should be passed before a Bank loan is approved by the Board.

- High quality sector work preceding a project is no guarantee of a successful outcome if supervision during implementation is neglected.

- Midterm reviews of projects provide a useful opportunity to rectify problems not anticipated at appraisal and should be undertaken systematically.

- The Bank's reluctance to use remedies at its disposal in the event of unsatisfactory borrower performance can be counterproductive to achieving project goals. Unfortunately, this project has shown that precipitate and ill-timed use of remedies produces even worse results.

- Lending directly to rural electrification umbrella agencies on IBRD terms for rural electrification projects is hard to justify except in the case of financially very strong entities.

Basic Data Sheet

Annex A

PHILIPPINES RURAL ELECTRIFICATION REVITALIZATION PROJECT (LOAN 3439—PH)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	111.9	60.9	54.4
Loan amount	91.3	54.6	59.8
Cofinancing	16.7	7.7	46.1
Cancellation		36.7	
Date physical components completed		n/a	
Economic rate of return		n/a	

Cumulative Estimated and Actual Disbursements

	FY92	*FY93*	*FY94*	*FY95*
Appraisal estimate (US$M)	2.0	8.0	23.0	58.0
Revised Estimates (US$M)		2.0	8.0	18.0
Actual (US$M)				2.0
Actual as % of appraisal				3.4
Actual as % of revised estimate				11.1
Date of final disbursement: April 30, 1998				

	FY96	*FY97*	*FY98*	*FY99*
Appraisal estimate (US$M)	86.0	91.3	91.3	91.3
Revised Estimates (US$M)	24.5	48.0	84.0	91.3
Actual (US$M)	17.3	45.0	55.3	54.6
Actual as % of appraisal	20.1	49.3	60.6	59.8
Actual as % of revised estimate	70.6	93.8	65.8	59.8
Date of final disbursement: April 30, 1998				

Project Dates

	Original	Actual
Identification		November, 1989
Preparation		April, 1990
Appraisal		March, 1991
Negotiations		December 9-12, 1991
Board presentation	September, 1991	February 25, 1992
Signing		June 3, 1992
Effectiveness		October 22, 1992
Project Completion	June 30, 1996	Ongoing
Loan closing date	December 31, 1996	April 30, 1998

Staff Inputs (staff weeks)

	Planned		*Actual*	
	Weeks	*US$ ('000)*	*Weeks*	*US$ ('000)*
Through Appraisal			85.4	257.4
Appraisal-Effectiveness			43.9	144.1
Supervision			87.0	256.3
Completion			10.5	17.5
Total			226.8	684.3

Mission Data

	Date (month/year)	No. of persons	Staff days In field	Specializations[a] represented	Performance rating: Implementation Status	Performance rating: Development Objectives	Types of problems
Through appraisal	2/90	4	5	FA, EC, PE, C			
	7/90	4	5	FA, PE, EC, C			
	11/90	2	4	FA, EC			
	3/91	4	12	FA, EE, PE, FA			Appraisal Mission
Appraisal through Board approval	9/91	3	3	FA, PE, EE			Post Appraisal
Board approval through effectiveness	9/92	2	2	FA, ED	S	S	Inconsis-tencies between NEA's evaluation reports and subprojects designed by its engineering department.
Supervision	5/93	4	2	FA, PE, EE, C	U	S	No progress with procurement since September, 1992.
	9/93	2	3	FA, PE	U	S	Delays estimated at up to 18 months.
	6/94	1	2	PE	S	S	Timely completion of staging areas and reimburse-ment of consignee RECs urged.
	8/94	1	7	FA	U	S	Serious slippage noted.
	6/95	1	7	FA	U	U	Extremely disappointing progress.
	5/96	1	7	FA	S	S	Substantial progress with procurement.
	11/97	3	10	ES, PS, OP	U	S	Procurement much behind schedule. Excess material problem identified.
	11/98	2	7	ES, OP	U	S	Excess material problem not yet solved.

a.· FA=Financial Analyst; PE=Power Engineer; EE=Energy Economist; EC=Economist; ES=Energy Specialist; PS=Procurement Specialist; C=Consultant; OP=Operations Officer.

FROM : NEA-FAPO Office PHONE NO. : 9292069 Jun. 15 2000 10:44AM P1

Republic of the Philippines
NATIONAL ELECTRIFICATION ADMINISTRATION

June 8, 2000

MR. RIDLEY NELSON
Acting Manager
Sector and Thematic Evaluations Group
Operations Evaluation Department
The World Bank

SUBJECT : DRAFT PERFORMANCE AUDIT REPORT
RURAL ELECTRIFICATION REVITALIZATION PROJECT
IBRD LOAN NO. 3439-PH

Dear Mr. Nelson:

We have gone over the draft Performance Audit Report and we concur with your findings and recommendations. Though we were saddened that NEA's performance was rated unsatisfactory, the report was very straightforward and fairly presented the facts for both the Bank and NEA.

We believe that the Bank's staff and NEA had exerted their best effort for the successful implementation of the project. Unfortunately, some unforeseen events took place and the implementors of the project at the time were caught offhanded.

This audit report will provide us with a good reference document and an insight to improve our performance in future undertakings.

Thank you and warm regards.

Very truly yours,

CONRADO M. ESTRELLA III
Administrator

1050 CDC Building, Quezon Avenue, Quezon City, Metro Manila, Philippines ☎ 374-25-27 / 374-25-58 / 374-25-59