

Action Fiche for Arab Republic of Egypt

1. Identification

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|---------------------------------------|---|--------|---|
| Title/Number | Energy Sector Policy Support Programme (SPSP) - ENPI/2011/22763 | | |
| Total cost | EU contribution: EUR 60,000,000 (EUR 30,000,000 in 2011; EUR 30,000,000 in 2012) | | |
| Aid method / Method of implementation | Sector Policy Support Programme: - Sector budget support (centralised management). | | |
| DAC-code | 23010 | Sector | Energy policy and administrative management |

2. Rationale and country context

2.1. Country context and rationale for SPSP

2.1.1. *Economic and social situation and poverty analysis*

The economy has proven resilient to the global crisis, thanks notably to appropriate reforms and stimulus actions implemented by the government of Egypt, as well as a low level of financial integration with world financial market. GDP growth was higher than expected at 5.2% in Fiscal Year (FY) 2009/10 thanks to consumption spending and production in the construction, communications and trade sectors, as well as a resurgence of tourism. Consumer price index (CPI) inflation, which lowered steadily during FY 2009/10, accelerated again at 10.9% in August 2010, with core inflation at 8.2%, i.e. slightly above the central bank's informal comfort zone. With growth expected at 6% in FY 2010/11, the priority should be to resume fiscal consolidation towards the 3% budget deficit (to GDP). While Foreign Direct Investment inflow levels compared to previous years remain low, portfolio inflows have picked up during FY 2009/10 and have shifted the level of international reserves to above its pre-crisis level.

As a result of this strong economic performance and appropriate policy reforms, Egypt has reported progress in most of the Millennium Development Goals. Poverty in Egypt remains widespread, mainly in rural (77% of the poor) areas, whereby the most acute areas are in Upper Egypt (40% poverty). Unemployment, at 9.4%, is concentrated among women and youths.

2.1.2. *National development policy*

Egypt's long-term development programme is set out in its 1997-2017 National Plan, which is put into operation through the Five-Year Plan. The Five-Year Plan is the main framework for planning investment in Egypt, in the absence of a Medium Term

Expenditure Framework. The Plan has been developed by the Ministry of Economic Development and adopted by the Government.

The latest Plan covers 2007/8-2011/12 fiscal years and focuses on socioeconomic development, notably through improving living standards and social security, economic growth and job creation and fostering private sector participation in the economy. Key targets of the plan are annual GDP growth rates of 8%, poverty reduction from the 20% to 15% and decrease in unemployment from 9.6% to 5.5%. Considering the 2008-2009 global crisis and its effect on the Egyptian economy, these ambitious targets are unlikely to be met by 2012, but are expected to remain feasible in the longer-term.

2.2. Sector context: policies and challenges

Sector context: The institutional setup of the energy sector in Egypt is still characterized by the overarching goal of providing sufficient subsidised energy supply and developing the oil and gas sector based on the country's own reserves. Both ministries responsible (Petroleum and Electricity) are supply-oriented and control economically important state-owned companies.

The Egyptian electricity sector is going through substantial changes and is evolving with the government by seeking alternatives and more efficient means to meet demand and secure energy. The high reliance on increasingly scarce crude oil and valuable natural gas has become a concern, as growing dynamic population and economic development are quickly driving up consumption. Sector reforms are starting to yield results, laying the ground for market liberalization and enhanced participation of the private sector.

In 2007, the government set the objectives of producing 20% of its electricity from renewable energy, to cut its green house gas emissions by 20% and to reduce its energy intensity by 20% by 2020. A recent study "Egypt Energy Strategy to 2030" has been endorsed by the government Supreme Energy Council with the aim to achieve the following : (i) ensuring long-term security of energy supply for Egypt; (ii) optimizing the use of the country's energy resources to ensure sustainable economic development; (iii) increasing the efficient utilization of energy in the local economy; (iv) ensuring that social objectives are met, by reconciling the need to ensure energy is affordable and all sections of society have access to basic energy services; and (v) promoting and enforcing the environmentally sound supply and consumption of energy. The Government now intends to include the selected policy options into a five-year action plan (or 'White Book' as mentioned in the EU-Egypt Energy Memorandum of Understanding (MoU)) (Annex 1: additional information on institutional reforms).

Assessment of the sector budget and its medium term financial perspectives: Energy sector development planning and costing is under the responsibility of the Ministry of Petroleum and the Ministry of Electricity and Energy. However, delivery of services and infrastructure investment is off-budget, i.e. under the responsibility of enterprises, either private or state-owned. State-owned enterprises (SOEs) finance their development from their own revenues, without direct government contribution. However, the potential impact of the energy sector on public finances is considerable

as SOE's investments, mainly financed through concessional loans from International Financial Institutions and Arab funds, are covered by state guarantees that create contingent liabilities.

Investment needs in the energy sector are considerable due to the high demand of growth patterns. EGP 73.6 billion (approximately EUR 10 billion) were needed to implement the 2007/8-2011/12 plan. The financial feasibility of the electricity and gas development plans may be jeopardised by limits to more concessional loans. Realising this, the government developed a policy to involve the private sector in sector development. Energy market liberalization reforms were launched with the objective, among others, to gradually limit the Government's involvement and contingent liabilities in sector development. An important element of reform will be to improve financial transparency of the energy sector, notably SOE financial reporting and quasi-fiscal activities and contingent liabilities arising from investments covered by the state's sovereign guarantee.

In addition, the government heavily subsidizes the energy sector through imposed low tariffs and reduced rates of return on its energy enterprises. Energy subsidies were expected to account for about 18% of total budget in FY 2009/10. The government had started to increase energy prices in 2004, but froze prices in the midst of the crisis in 2008. More transparency is a preliminary condition to tariff and subsidy reforms.

Donor coordination: The reform process is coordinated by the Supreme Energy Council and chaired by the Prime Minister, while donors have established a Development Partner Group for Energy and Environment.

Assessment of institutional capacity: The institutions which will be involved in the Energy SPSP have the basic capacity necessary to implement what will be required, but complementary technical assistance (TA) will be necessary to accompany reforms.

Performance monitoring: Performance monitoring activities are coordinated by the ruling party's energy committee but are rather input-oriented. It is envisaged that a comprehensive and centralised performance monitoring framework for the energy sector should be established as part of the future five-year action plan ('White Book').

Macroeconomic framework: The Egyptian economy managed to maintain its growth momentum during FY 2009/10, registering a preliminary GDP growth rate of 5.2% compared to 4.7% in FY 2008/09, against the backdrop of a slow global economic recovery after the 2008 economic crisis. The rebound in growth has been driven mostly by private sector consumption, on the back a series of government fiscal stimulus packages, and by strong activity in sectors like construction and telecommunications. Key sectors in Egypt have been gradually recovering; however Suez Canal revenues are still lagging behind pre-crisis levels, due to the persistently lower global trade volume and a still weak EU economic recovery (Annex 2: Additional information on the macroeconomic framework).

Public Financial Management (PFM): Several PFM diagnostics exercises have been conducted in the last 4-5 years with the support of donors. Taking the Public Expenditure and Financial Accountability (PEFA) as the most analytical and most recent of such exercise, and analysing PFM from the perspective of the six core dimensions of the PEFA, it appears that Egypt's PFM system functions fairly well and supports the three budgetary outcomes of fiscal discipline, resources allocation efficiency and service delivery. (Annex 3: additional information on public finance management).

2.3. Eligibility for budget support

Egypt is eligible for sector budget support based on the analysis undertaken.

Eligibility criterion 1: A sector development or reform policy and strategy. The government endorsed in February 2010 a study for an 'Energy Strategy 2030', and now intends to develop a five-year Action Plan (or 'White Book' as mentioned in the EU-Egypt Energy MoU) where it will select key priority policy options for the midterm. Finally, the government has drafted a new Electricity Law that organizes the gradual liberalization of the energy market. In addition, the Government is considering a reform of the gas market regulation.

Eligibility criterion 2: A sound macroeconomic policy. Egypt's economy has grown steadily in the last five years and proved resilient to the international financial crisis. The IMF has recently commended the Government for its macroeconomic policies and for its appropriate reaction to the recent global financial crisis.

Eligibility criterion 3: A satisfactory trend in PFM reform. The Ministry of Finance has achieved considerable progress in improving the PFM system in the last six years, notably budget transparency. As the Ministry of Finance is currently launching a fiscal decentralisation reform, the ad hoc inter-ministerial committee created for that purpose has started working on formulating a comprehensive strategy document for PFM improvement.

2.4. Lessons learnt

The proposed Energy SPSP takes into account lessons learnt from previous SPSPs in other sectors in Egypt, and hence favours: (i) the use of variable annual instalments and (ii) the design of conditions which will not depend on the fulfilment of other conditions, so as to avoid a domino effect.

Additionally, experiences of other donors (mainly World Bank), such as the failure to promote increased energy tariffs through conditionality, were taken into account during the formulation phase. Indeed, it has proven more effective to support the policy dialogue and to focus on good corporate and public administration governance such as promoting transparency of financial operations in the energy sector, thus exposing quasi-fiscal activities, the real cost of subsidies to the society, their inequity and their distortional impact on the market and sector development.

2.5. Complementary actions

In order for the Energy SPSP to achieve maximum effectiveness, complementary action is needed in the form of specific advisory and Technical Assistance projects, including the ones already in progress and planned at national and regional levels, as well as short-term missions for audit, evaluations and reviews. These actions need to be coordinated with those of other donors, in particular the European Investment Bank, the World Bank, *Gesellschaft für Internationale Zusammenarbeit* and *Kreditanstalt für Wiederaufbau*, United Nations Development Programme, African Development Bank, *Agence Française de Développement* and Japan International Cooperation Agency. A technical assistance contract of EUR 1,000,000 was awarded to provide support in terms of capacity building to the Egyptian Electricity Regulator (EgyptERA).

2.6. Donor coordination

Donors have established a Development Partner Group for Energy and Environment. The Group meeting on a monthly basis to discuss energy issues has ensured a high degree of coordination among donors. The Group was consulted during the preparation of this SPSP.

3. Description

3.1. Objectives

The overall objective of the proposed Energy SPSP is to assist Egypt in putting in place and implementing its programme of energy reforms as well as fostering implementation of its strategic energy partnership with the EU with the purpose of improving energy security and sustainable development.

The specific objectives of the proposed SPSP are to: (i) improve the energy policy and regulatory framework; (ii) improve financial transparency and performance of the energy sector; (iii) promote development of renewable energy sources and mitigation of Greenhouse gas emissions; and (iv) promote energy efficiency.

These objectives are in line with the study “Energy Strategy 2030” endorsed by the Supreme Energy Council in February 2010 and the EU-Egypt MoU for an Energy Strategic Partnership. The commitment of Egypt to develop renewable energy potentials and programmes for more efficient utilisation of energy will have a strong impact on the environment.

3.2. Expected results and main activities

The expected results and main activities are as follows:

- (1) Improvement of the energy policy and regulatory framework
 - Update of the energy policy framework:
 - Progress in converging energy market regulations with those of the EU

- A proposal for the regulation of the Egyptian gas sector
- (2) Improvement of the energy sector financial transparency and performance
- Improved transparency of electricity tariffs and subsidies
 - Improved transparency of fiscal risks arising from state guarantees
 - Improved financial transparency of SOEs:
- (3) Promote the development of Renewable Energy sources
- Widen the use of solar water heaters in buildings:.
 - Wind and solar power development programmes are on-track
- (4) Promote Energy Efficiency
- Consolidation of the Energy Efficiency institutional and policy framework
 - Energy savings programmes for public buildings and street lighting are pursued.

3.3. Risks and assumptions

The basic assumptions underlying the Energy SPSP are the following:

- Prevalence of political, economic and social stability in Egypt.
- Sustained commitment of Egypt to the ENP Action Plan and EU-Egypt strategic energy partnership.
- Sustained commitment of Egypt to energy sector reforms, including energy pricing.

The risks underlying the Energy SPSP are set out in the table below:

| Risks | Level¹ | Risk mitigation measures |
|---|--------------------------|--|
| Commitment of all Energy SPSP partners to engage actively in a sector approach and raise the level of policy dialogue with donors and among themselves. | M | Involvement of the Ministry of Finance at an early stage in the preparation and implementation phases of the SPSP. Focus of the SPSP on areas where there is a clear committed counterpart or wide consensus in government. |
| Slow progress of energy reforms until the end of the electoral process in | H | Most of Energy SPSP conditions will be assessed |

¹ Risks are broadly divided in low (L), medium (M), and High (H)

| | | |
|---|---|--|
| Egypt (parliamentary and presidential elections). | | in FY 2012/13 and 2013/14, i.e. well after the end of the electoral process. |
| Insufficient human resources. | L | Build the necessary human capital through complementary actions. |

3.4. Stakeholders

The key stakeholders consist of the Ministry of International Cooperation, Ministry of Finance, the Ministry of Petroleum, the Ministry of Electricity & Energy, the electricity regulator EgyptERA, the Secretariat of the Supreme Energy Council ('Energy Efficiency Unit'), the New and Renewable Energy Authority and the Egyptian Electricity Holding Company.

3.5. Crosscutting Issues

The commitment of Egypt to the development of renewable energy potentials and the programmes for more efficient utilisation of energy will have a strong impact on the environment. The Energy SPSP will have a significant impact on the environment with the reduction of greenhouse gas emissions and other pollutants in order to achieve more efficient utilisation of energy resources and development of renewable energies in all sectors of the Egyptian economy. The estimated reduction of GHG emissions for solar and wind power plants considered in the Energy SPSP as targets will amount to 2,400,000 tons CO₂ per year when connected to the grid and operational while the energy efficiency measures should lead to a reduction of 280,000 tons CO₂ per year.

The approval of the Electricity Law, the preparation of the White Book and the work on the gas sector regulation will also lead to positive environmental impacts in the medium and long term and lead to successful achievements in climate change. Finally, the Energy SPSP also addresses energy tariff reform through better transparency of service costs and through expected resumption of annual tariffs increase. These will positively impact the consumer's behaviour regarding energy use which will lead to a better environment (Annex 4: additional information on crosscutting issues).

4. Implementation issues

4.1. Method of implementation

Direct centralised management for both the budget support and the TA components (service contracts) of the Energy SPSP, through the signature of a Financing Agreement with the Government of Egypt.

4.2. Procurement and grant award procedures

All contracts implementing the action must be awarded and implemented in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of

the launch of the procedure in question. Participation in the award of contracts for the present action shall be open to all natural and legal persons covered by ENPI regulations. Further extensions of this participation to other natural or legal persons by the concerned authorising officer shall be subject to the conditions provided for in 21(7) ENPI.

4.3. Indicative budget and calendar

The total amount of the programme is EUR 60,000,000. EUR 30,000,000 will be committed in 2011. This will be complemented by an additional EUR 30,000,000 from 2012 funds subject to the availability of budgetary resources. The additional commitment of EUR 30,000,000 will be made as soon as 2012 commitment credits become available. EUR 56,000,000 will be earmarked for budget support to be split up into three tranches. All tranches shall be released after the Commission services ascertain that the conditions for each instalment are met. The programme will allocate EUR 3,500,000 for TA and EUR 500,000 for monitoring, audit, visibility and evaluation purposes. The operational implementation phase will last 36 months.

4.4. Performance monitoring and criteria for disbursement

A Steering Committee (SC) shall constitute the platform for policy dialogue between the European Commission and all SPSP stakeholders. The SC will be in charge of monitoring the SPSP implementation. It will be assisted in this task by external monitoring missions that will take place at least once a year and will give an independent evaluation of the general progress of the programme and the fulfilment of criteria attached to the disbursement of each budgetary support instalment. These external monitoring missions will be contracted by the EU and financed from the SPSP complementary action budget.

4.5. Evaluation and audit

An external evaluation, contracted by the European Commission will be carried out at the end of the programme. This does not preclude the European Commission to require interim evaluations if deemed necessary.

4.6. Communication and visibility

The Energy SPSP will follow the “Communication and Visibility Manual for EU External Actions” issued by the European Commission. Proper communication and visibility of the action will be achieved via regular joint communication events, in particular on the occasion of the release of budgetary support instalments.