



July 2, 2009

Mr. Bright Msaka  
Chief Secretary to the President and Cabinet  
Government of Malawi  
Private Bag 301  
Lilongwe, 3  
Malawi

Dear Mr. Msaka:

On behalf of the Millennium Challenge Corporation (MCC), I would like to thank the Government of Malawi (GoM) for the submission of its Energy, Transport, and Governance Project Concept Papers. In particular, I wish to recognize the MCA-Malawi team, led by Ambassador Sam Kakhobwe, for its efforts to develop the concept papers based on analysis of the constraints to growth confirmed through an extensive consultative process.

In response to the GoM's submission of concept papers, MCC has undertaken a thorough assessment with both internal and external experts that culminated in a final review by MCC's Investment Committee (IC) in June 2009. We assessed the concept papers on the basis of the following criteria: a) soundness of project rationale and program logic; b) expected economic impact; c) expected poverty impact; d) implementation considerations; e) level of project preparedness (recognizing the GoM's target of signing a Compact in 2010); f) sustainability; g) need for and likelihood of key policy reforms; and h) environmental and social risks. Our assessment also was informed by our implementation experience in 18 countries that have signed compacts with MCC. Finally, MCC considered the potential funding envelope for a compact with Malawi of approximately USD 300 million. The IC also approved the proposed use of up to USD 14.8 million of funding under Section 609(g) of the Millennium Challenge Act, as amended, for further project development and pre-implementation support.

Based on this assessment, MCC Management agreed to:

- **Proceed with further project development** of a subset of the most urgent proposed investments in energy and associated improvement in natural resource management (NRM), utilizing MCC grant resources. These include the following:
  - 1) Improving the availability of higher quality, more reliable power through (i) rehabilitation of hydro-power stations; (ii) installation of meters to reduce peak

- demand growth; (iii) rehabilitation and upgrading the transmission system; (iv) improve protection, control and data acquisition for the T&D system
- 2) Increasing access to power for un-served users through (i) rehabilitation of the distribution systems in each region; (ii) network extension in peri-urban areas; and (iii) development of renewable off-grid power source to connect farms, households and businesses in rural areas using output based aid.
  - 3) Improving and effectively managing the power sector for improved service delivery.
  - 4) Improving water resource and land management in priority catchments in the Shire River Basin to: (i) help alleviate weed and siltation problems that affect the performance and sustainability of power generation facilities, and (ii) protect water, soil, and other natural resources vital to rural lives and livelihoods.

We believe these proposed interventions, if accompanied by critical policy and institutional reforms, would significantly strengthen performance of the power sector and would prepare it for additional public and private investments.

- **Conduct further diligence** of the proposed feeder road project in the Transport Concept Paper and return to MCC's Investment Committee (IC) in September 2009 for a decision on whether to proceed with further project development. The IC expressed concern about the rationale and economic viability of the feeder roads proposed, and asked for more information on the impact of transport policies on shipping costs.
- **Consider a reduced scope for proposed governance investments**, to support targeted activities within the energy and transport projects to improve public financial management capacity within the institutions implementing or affected by those projects.
- **Not proceed with further development** of the Nacala rail project, establishment of a transport regulator agency, construction of new 220 kV and 132 kV transmission lines, and the Malawi Rural Electrification Program (MAREP). Annex I to this letter provides a detailed explanation of these decisions. In the case of the rail and transmission projects, MCC determined that they represent substantial timeline risk due to significant environmental and social issues, are likely to cost far more than estimated in the concept papers, and are not economically viable at this time. MCC is willing, however, to fund full feasibility studies, Environment Impact Assessments (EIAs), and Resettlement Action Plans (RAPs) for the 220 kV transmission line given the long-term need for this asset in Malawi.

The IC also identified policy and institutional issues that may pose significant risks to the success of the proposed projects, and that we will explore further with MCA-Malawi and GoM agencies. We expect that MCC and GoM will need to come to an agreement on some policy actions as a condition for MCC compact funding. Our most significant concerns are summarized below:

- **Energy:**

- 1) Assessment of the ESCOM's operating and maintenance costs required for sustainability of the existing infrastructure as well as MCC's proposed investment, and a commitment by the GoM to sufficient tariff increases and a realistic tariff implementation schedule to cover these costs;
- 2) GoM-adopted reforms and enhanced legal and regulatory frameworks for the power sector, including: harmonization of electricity laws; improved governance and rationalized roles and responsibilities of relevant institutions (i.e. Ministry of Energy and Mines, Department of Energy, Malawi Energy Regulatory Authority, ESCOM, and the Privatization Commission); and provision for private sector participation in the sector;
- 3) Award of the Kapachira II construction contract and effectiveness of the World Bank Interconnector credit agreement and commencement of this project; and
- 4) Institutional changes to improve ESCOM's performance to ensure a successful financial and operational turn-around, including but not limited to consideration of project and management contracts.

- **Natural Resource Management (NRM):**

- 1) An explicit commitment by the GoM, and a strong champion within government, to lead the development and implementation of the NRM components of the power sector project;
- 2) Appointment of a lead agency to work with MCA-M to prepare and implement a cohesive NRM sub-project. This agency, and the individual(s) appointed to manage the project on behalf of the lead agency, should have the responsibility and the political authority and stature to promote effective intra- and inter-agency cooperation, stimulate policy dialogue, and coordinate the activities of donors, civil society and private sector.

- **Transport:**

- 1) Greater clarity, and if deemed necessary after further study, adequate GoM actions to address key policy, institutional, and regulatory issues, including competitive structure of sector, road asset preservation (maintenance responsibilities and funding, and axle load control), road-safety issues, licensing and permitting, and other transport sector policies restricting entry and competition and hidden barriers to trade; and
- 2) Consideration of a comprehensive transport sector plan for Malawi, with possible support from MCC.

The attachment to this letter provides a more detailed summary of our assessment of the proposed projects, including further discussion of the issues summarized above. It also contains recommended next steps associated with design and appraisal of the projects. We intend to engage fully and collaboratively with MCA-Malawi and GoM technical agencies to address all key technical, policy and institutional issues and to mobilize resources needed to ensure that the

projects are sufficiently developed prior to submission of a formal compact investment proposal to the IC and MCC Board of Directors. MCC's IC approved the proposed use of USD 14.8 million under our Section 609(g) funding authority to initiate the technical preparation of these projects, including feasibility studies and environmental and social impact assessments, as well as other analytical studies that will further project analysis and development.

This extensive preparatory work will involve a substantial commitment of time, effort, and funds from both the GoM and MCC; however, based on lessons learned, we believe that this will lead to a more defined compact with projects that Malawi will be able to implement within the five-year constraint of an MCC Compact. During MCC's July 2009 trip to Malawi, MCC will share detailed recommendations with the GoM on next steps in regards to developing the projects further, addressing key policy issues in the relevant sectors, responding to additional human resource requirements, and continuing to coordinate with donors in the project areas.

I am deeply appreciative of your personal commitment and the hard work of the MCA-Malawi core team and their counterparts in GoM agencies. MCC looks forward to continued collaboration with your government and to a successful compact development process.

Sincerely,

A handwritten signature in black ink, appearing to be 'DT', written in a cursive style.

Darius Teter  
Acting Vice President for Compact Development

cc: Inter-ministerial committee  
Secretary to the Treasury  
Mr. Sam Kakhobwe  
U.S. Ambassador Peter Bodde

**Attachment I:**  
Assessment of Projects, Proposed Use of Funding Under Section 609(g) of the  
Millennium Challenge Act, and Next Steps

**ASSESSMENT OF PROJECTS**

**1) Energy Project**

Overall Assessment

The stated goal of the Energy Concept Paper is to further economic growth and poverty reduction through the increased accessibility to more reliable and quality power supply for commercial and domestic use within Malawi. MCC accepts this rationale, finding that the CP and supporting documents make a reasonable case for the need to upgrade, rehabilitate, modernize and expand the power system. We also believe that there is great opportunity to redress some of the long-standing issues that have plagued the sector's performance and prepare it for additional public and private investment that are critical to expansion. We believe the following set of investments by MCC could set that stage, if accompanied by requisite policy and institutional reforms by the GoM.

MCC will proceed with additional due diligence and feasibility studies and EIAs on the following activities:

- To improve availability of quality and reliable power supply, through:
  - Rehabilitate Nkula 'A' and 'B' power stations to increase
  - Install maximum demand meters and implementation of feeder metering to help regulate demand and supply at peak times
  - Upgrade the Chintheche – Mzuzu line from 66kv to 132 kv, including a new transformer
  - Install new transformers at four sub-stations
  - Purchase of two dredgers for silt management at Kapichira and Tedzani power stations and an additional weed harvester at Liwonde barrage
- To increase access to power for un-served users, through:
  - Rehabilitate the electrical supply systems in the southern, central and northern regions
  - Extend the power network in peri-urban areas
- Develop renewable off-grid power sources to connect farms, households and businesses in rural areas, in partnership with the private sector, using output based aid. To improve the efficiency of ESCOM's operations, including a possible management contract
- To improve natural resource management and enhance sustainability
  - Funding for catchment management studies to identify prioritized NRM interventions in select sub-catchments upstream of proposed power infrastructure

That said, MCC has decided not to support further development of several proposed components for the following reasons:

- *Construction of new 220 kV and 132 kV transmission lines:* Both projects have significant technical, environmental and engineering challenges, lack project preparatory work, and demonstrate high implementation and completion risks, as well as questionable short-term benefits. While MCC is not willing to fund these construction projects in the short-term, we are willing to fund full feasibility, Environment Impact Assessment (EIA), and Resettlement Action Plan (RAP) studies for the 220 kV transmission line given the importance of this as a long-term investment for Malawi.
- *Expansion of the Malawi Rural Electrification Program (MAREP):* Due to the generating capacity constraints in the system, there is a risk of destabilizing the existing system with MAREP expansion and negatively impacting other MCC investments due to the poor load shape of rural marginal customers. However, MCC does support proceeding with the Public-Private Partnership (PPP) / Output-Based Aid (OBA) component also proposed in the Concept Paper to increase rural electricity access in Malawi.

For the subset of energy projects that remain, the project prioritization and selection process for the proposed projects will need to be verified through technical and economic analyses.

### Key Issues and Risks for Energy Concept Paper

*Assessment of Expected Economic Impact:* MCC found that some of the projects could exceed MCC's hurdle rate and ERRs if the projects are well designed and if governance and policy reforms in the sector are sufficiently robust to turn around the sector. The approach taken to estimating the ERRs in the concept paper was reasonable; however, there is a risk that costs as estimated will escalate dramatically once full feasibility and design are conducted. Further project definition and empirical evidence of impacts will, therefore, lead to a revision of these ERRs. There is empirical evidence at both the macro- and micro-economic levels that power sector issues constrain growth in Malawi and increase production costs<sup>1</sup>. The ERRs may nonetheless be lower than desired if the project is not successful in increasing the reliability and supply of electricity substantially enough, given the volumes of capital invested. A concerted sectoral reform program that is embraced by the GOM and persists beyond the Compact will be required to achieve this objective.

*Beneficiary analysis:* Currently only 7.6 % of the population (or approximately 1 million people) has access to electricity, while the electrification rate in rural areas is only 1 – 2 %. Based on connection trends estimated by MCA and ESCOM, approximately 15,000 – 20,000 new households and businesses along the existing grid will be connected every year during the

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<sup>1</sup> According to the 2008 “Africa Infrastructure Country Diagnostic”<sup>1</sup> Malawi had the highest days per annum with power outages, approximately 64 days, among the 24 southern African (SSA) countries surveyed. Recent studies have stated that economic losses relating to power outages in SSA average 2.1% of a country's GDP<sup>1</sup>.

life of the project.<sup>2</sup> The direct beneficiaries of the proposed energy program will be mostly skewed towards non-poor as current electricity users are mainly urban-based, less poor households and businesses. However, the 30,000 rural small enterprises and households already connected through the first six phases of the MAREP program may also benefit from increased reliability and quality supply of power. In addition, approximately 20,000 rural customers may obtain access to electricity through the proposed Public-Private Partnership (PPP) project to increase access. The primary objective of any MCC investments in the energy sector would be the indirect benefits through employment creation, opportunities for small enterprises in urban and rural areas, and productivity improvements. Although we do not know how many poor people will gain employment as a result of the MCC-funded project, it is highly probable that if power supply and quality issues are convincingly remedied, the poor will benefit more in the long term from the resulting economic growth. If, on the other hand, these issues are not remedied, productive sectors will continue to incur economic losses and there would be severe negative repercussions that would impact poor and non-poor alike.

*Implementation considerations:* The proposed implementation structure needs to be reconsidered to possibly include a professional project management firm. If a Project Management Consultant (PMC) firm is selected, the PMC would take responsibility for management of the MCC-funded project. A management contract has the benefit of introducing incentive structures so that in addition to more operational and financial efficiency, project delivery is also accelerated. ESCOM had previously entered into a management contract with ESKOM (South Africa) which ended several years ago. MCC will diligence ESCOM's past history with performance contracts.

In terms of the program flexibility, only some of the projects are scalable, namely the network expansion/access project. This limits the options to re-scope the program in case of budget shortfalls or other implementation challenges.

*Level of preparedness:* As presented in the Concept Paper, information on proposed projects is lacking, which raises the risk for schedule and completion. Surveys, feasibility studies, environmental and social impact assessments, and preparation of technical specifications and bid documents for design-build contracts typically require at least nine - twelve (9-12) months. MCC is in the process of revising the ESCOM-drafted Terms of Reference (ToR) for the technical, economic and ESA studies for rehabilitation of the generation and T&D assets and the PPP project. [The construction of the proposed new 400 km 220 kV and 80 km 132 kV lines would involve significant technical/engineering and environmental/resettlement challenges; thus, in the absence of any feasibility studies or EIAs, MCC concluded that these proposals posed too significant implementation and completion risks for MCC to undertake. However, because of the potential importance of these lines as power availability expands, and to redress this issue of preparedness that any future investor would face, MCC is willing to consider funding the feasibility study and EIA for the 220kV line under the compact].

*Sustainability:* The key sustainability risks are as follows:

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<sup>2</sup> Currently 80 % of customers are domestic users, while 19 % are from the commercial and industrial sector. This data is from ESCOM's website. <http://www.escommw.com>

- Inadequate tariff levels and poor maintenance: Current electricity rates do not recover operating and maintenance (O&M) costs, much less capital expansion costs. ESCOM has applied for a 54% tariff increase, which is expected to be approved and implemented (on a staggered basis) by the beginning of July 2009. It is imperative that this tariff increase be formally approved and implementation initiated prior to MCC's Investment Committee follow-up review in September 2009. Then, during the coming months, MCC will need to work with MCA-Malawi, ESCOM and MERA to assess the true operations and maintenance funding needs, and the implications for any future tariff increases, related to the enhanced generation and distribution system. As part of the eventual compact that includes major investments in the energy sector, MCC will require a commitment by the GoM to sufficient tariff increases and a realistic tariff implementation schedule, and GoM agreement to ensuring annual allocation of sufficient maintenance funds and evidence that the funds are being expended for the intended purpose.
- Operational Inefficiency: Poor financial and revenue management by ESCOM cause persistent working capital challenges that also exacerbate the company's debt burden. MCC will require an audit of ESCOM's books by an international accounting firm. ESCOM has a low bill collection rate, connection backlogs, and high technical / non-technical losses. Consequently, financial management has been poor, leading to perennial operational problems. MCC is considering recommending a management contract to address ESCOM's operational and financial inefficiencies and to reduce implementation risk of the energy sector project of the Compact. We will review this proposal with MCA-Malawi and the GoM.
- Institutional Management: There is myriad of agencies operating in the energy sector that appear to create confusion around roles and responsibilities, as well as inefficiencies; the current situation may impede efforts to improve performance in the sector. For example, both MERA and the Department of Energy (DoE) (with support from the International Atomic Energy Agency) propose overseeing the capacity expansion planning process. There are also ambiguities regarding certain roles and responsibilities of the Privatization Commission with respect to the power sector. To ensure better management of the sector over the long term will require a review of the regulatory and operational structures in the power sector, as well as the roles and responsibilities of all major actors in the oversight, operations and management of energy in Malawi. As a result of this review, MCC would expect to enter into a dialogue with the GoM, prior to completing compact development, about recommended revisions to current structures and responsibilities.
- ESCOM Governance: Management of ESCOM and the governance of the energy sector need to be addressed before compact signing. MCC will likely require the ESCOM Board to include independent professional members who can add value to the efficient management of the organization.

*Key policy reforms*: Various reforms are needed to increase supply and improve operations within the sector. The Electricity Law needs to be revised to allow full and open third-party access to the grid by private generators of all sizes (now limited to below 5 MW). MCC recommends a thorough legal and institutional review of the existing Electricity Law. As it

proceeds with compact development, MCC will work closely with MCA-Malawi and the GoM on requisite reforms and collaborate with other donors, such as the World Bank, DfID and African Development Bank, to harmonize policy reform recommendations.

*Environmental and social safeguards:* Several of the major activities will require Category A EIAs due to their scale, scope and their potential to affect substantial numbers of people, structures, and environmental resources. Where necessary, preparation and implementation of RAPs may require significant effort and time. Other environmental and social issues, including public health and safety, HIV/AIDS, and waste management would also need to be taken into consideration.

The proposed weed and siltation management activity, which involves the purchase of an additional weed harvester and dredging equipment, presents a different set of safeguard issues. A separate environmental assessment will need to be undertaken prior to an investment decision to assess the potential impacts that harvesting and dredging operations have on the river, particularly protected or sensitive areas, as well as other potential impacts associated with the weed and silt disposal operations. Moreover, purchasing additional equipment is strictly a stop-gap measure which does not address the underlying land and natural resource management practices which cause erosion and likely accelerate weed growth, and it is not clear that mechanical equipment is the most appropriate and effective means of managing the siltation and weed problems. Other options, including chemical and manual alternatives, should be examined as part of the environmental assessment. A more comprehensive approach is suggested, as described in the “cross-cutting issues” section below.

*Other issues and risks:* The viability of MCC investments are dependent upon the completion of complementary project activities currently not funded by MCC. To ensure that MCC investments are successful and sustainable: (a) The GOM must award the Kapachira – II construction contract before compact signing and; (b) the World Bank’s Mozambique Interconnector credit must be approved and commissioned before MCC compact signing. These two investments are badly needed to bridge the supply / demand imbalance and improve reliability and quality of power supply system, and to provide additional power for network extension (which is already experiencing serious load shedding).

### **1a) Cross-cutting Issue: Natural Resource Management (NRM)**

#### **Overall Assessment**

Environmental degradation is a critical and cross-cutting issue in Malawi that affects the sustainability of power, transport, and other infrastructure, impedes long-term economic growth, and adversely affects rural livelihoods and well-being. Deforestation, erosion, and sedimentation are Malawi’s most serious environmental threats. These problems are largely attributed to Malawi’s heavy reliance on bio-fuels (wood and charcoal) for cooking, as well as intensive and unsustainable agricultural and land use practices. The problems are most pronounced in the southern region of the country, including the Shire River Basin, where population densities are highest. Poor land and natural resource practices are severely damaging soil, water, and other natural resources which Malawi depends on for its water supply, hydropower, agriculture, and

other social services. The problems are compounded by an extensive weed infestation problem in the upper Shire River, which is likely caused by a combination of natural and anthropogenic factors. Sedimentation and weeds damage power plant turbines and increase operation and maintenance costs. It also reduces base flows (which reduces hydropower output), increases flooding (which leads to more washouts of roads and rail, and impacts farmers), affects agricultural productivity (as a result of soil loss), and affects water quality which harms water supplies, among other things.

The Concept Papers for both energy and roads acknowledge the importance of these problems, particularly with respect to its direct effect on the sustainability of the infrastructure investments proposed as well as its relation to rural development and growth. The concept papers propose two specific activities, totaling approximately USD 15 million, to help address these problems:

- Purchase of additional weed harvesting and dredging equipment to support hydropower operations in the Shire River Basin (US \$ 7 million, as part of power sector project)
- Funding for catchment management studies to identify prioritized NRM interventions in select sub-catchments upstream of proposed power infrastructure and road investments (US \$ 8 million total – US \$ 4 million in each concept paper).

The proposed catchment management studies would involve an integrated assessment of the social, economic, and environmental dimensions of land use and resource management problems in each sub-catchment, with the primary objective of identifying and prioritizing specific interventions, which MCC and/or other donors could fund. The studies would focus on livelihood-based solutions, as well as issues pertaining to governance, decision-making, resource rights and controls, and social equity. MCC will work with MCA-Malawi and stakeholders to further define the proposed studies. Additionally, as discussed above, an environmental assessment would be required prior to an investment decision on the weed harvester and dredger to determine whether mechanical measures are the most environmentally and economically appropriate management options.

Initial conversations with government, donors, NGOs, and other stakeholders indicate there is widespread awareness of the relevance and magnitude of the environmental and land use problems in Malawi, and numerous efforts are being undertaken by donors and NGOs to help address the problems. However, by the GOM's own admission, more needs to be done. Specifically, a clear and high level commitment within the GOM is integral to bringing about the necessary focus, coordination, and policy dialogue required to reverse current trends, strengthen environmental governance and capacity, and incentivize people to adopt more sustainable land use practices. This type and level of commitment is important to the success of any NRM investment MCC might fund, as well as the long-term health and prosperity of the country.

As an initial step, MCC recommends that funding under section 609(g) for the aforementioned NRM activities be conditioned on GOM's appointment of a relevant and dedicated lead agency (implementing entity) to work with MCA-M to prepare and implement a cohesive NRM project. The Concept Paper indicates that these activities would be implemented by ESCOM and MoTPW, but these entities seem to be neither the most appropriate implementing entities for an NRM project nor likely champions to move a broader NRM policy dialogue forward. Rather, the

GOM should appoint an agency with the appropriate sectoral responsibility and the political authority and stature to promote effective inter-agency cooperation, stimulate necessary policy dialogue, and coordinate the activities of donors, civil society and private sector. Upon appointment of a lead agency, 609(g) funding would be made available for technical assistance to support the implementing entity and MCA-M, and for the preparation of initial environmental and catchment management studies to inform the design of an integrated NRM project.

## **2) Transport Project**

### Overall Assessment

MCC appreciates that high transportation costs are a significant constraint to Malawi's economic growth. Toward that end, MCC is willing to consider 3-5 road segments that: would have a strong growth and poverty reduction story, in terms of significant economic impact (that is, an ERR of at least 12 percent) and direct impact on the poor; and do not have serious environmental issues, including resettlement, that would impair the ability to complete the road construction in five years.

Following a thorough assessment of the Transport Concept Paper by MCC and external peer reviewers, MCC has decided not to support further development of several proposed components for the following reasons:

- *Rehabilitation of the Nacala rail line:* MCC determined that the Concept Paper did not provide a strong link between the substantial reduction of transport costs and rehabilitation of the Nacala rail line, particularly in the absence of a sector-wide strategy based on rigorous modeling of demand which incorporates network effects, competition between and within transport modes, and differential port service quality issues. In addition, MCC agrees with other donors that a regional approach to investing in and governing the rail sector is required, as well as addressing the efficiency of Nacala port operations, especially given the relatively high proportion of benefits to Malawi's neighbors relative to the high cost of complete rehabilitation of the line within Malawi. Moreover, this proposal posed significant environmental and resettlement challenges, and given its current state of disrepair it is more akin to a reconstruction than rehabilitation project; consequently, it is doubtful it could be completed within MCC's five-year window. After a thorough review of the proposed rail project, MCC therefore found that it could not move forward with this project due to the size, regional scope, external risks and technical complexity of the project, as well as the time required to address the economic and governance / management issues in the sector.
- *TransRA:* The concept of creating a new transport regulator (TransRA) and regulatory / institutional reform and capacity building are potentially important steps for sector reform. However, there was not enough information in the CP to make a persuasive case for the specific regulatory project proposed.

MCC has decided to conduct further diligence of the proposed feeder roads. Although the three segments proposed in the Transport Concept Paper may have low economic returns due to low traffic counts and MCC's revised cost estimates, MCC staff and consultants will work with MCA-Malawi, Ministry of Transport and Public Works, and the National Roads Authority to identify the best possible road segments for additional due diligence. MCC's Investment Committee also expressed concern about the attendant policy reforms that would need to be addressed to support the investment and maximize the project's impact on reducing transport costs in Malawi. So, when it reconvenes in September, the Investment Committee will decide whether to proceed with further roads project development. The following sections provide a further description of some of the key issues and risks that pertain to the feeder roads.

### Key Issues and Risks for the Feeder Roads Project

*Program Rationale/Program Logic:* Overall, MCC found that the logic surrounding the objective of reducing transport costs on feeder and domestic roads is clear, and it is likely that upgrading of such roads, coupled with policy improvements in the road haulage sector, could reduce transport costs significantly. The Concept Paper does not, however, clearly explain the basis for the individual roads selected nor how the road selection fits into Malawi's larger road sector program and national transport strategy. Subsequent discussions with the MCA, World Bank's Spatial Analysis Team, Ministry of Transport and Public Works (MoTPW), Ministry of Finance (MoF), Road's Fund (RF) and National Roads Authority (NRA) revealed that the road segments were selected based on 1) priorities identified by NRA, 2) a desire to promote regional equity in terms of new investments, 3) prioritization of areas with a potential to diversify the economy into new sectors, and 4) connecting isolated areas with high economic potential to international corridors. MCC's July 2009 mission will continue to diligence these issues.

*Assessment of Expected Economic Impact:* MCC found that the economic viability of upgrading the roads to the high design standard proposed in the Concept Paper is most likely not viable, given the traffic counts of 100 - 120 motorized vehicles per day. It does not appear that the cost of a fully engineered roads would be justified based on vehicle operating and time cost savings alone (although the exact standard envisioned has not been well communicated to MCC to date), even if one included the benefits to non-motorized traffic (e.g. bicycles). However, upgrading to some lesser standard suited to the likely types and volumes of traffic prevalent on these roads may be a viable approach. In principle, an upgrade may also open up the impact areas to more motorized transport which could be more cost-effective for transporting goods long distances, connecting producers to markets, and citizens to essential social services. Nonetheless, MCC usually finds that even with these benefits fully captured and quantified, an expensive upgrade to a rural road with low traffic volumes is not justified economically. Hence, it is critical for MCA-Malawi and the DRA to consider whether the most viable road segments and appropriate design standard have been proposed to MCC for consideration. We would welcome alternative proposals, but such a decision must be made early in the July 2009 mission to permit MCC staff and consultants to complete requisite due diligence before the Investment Committee makes a final decision on whether to proceed with additional design work on this project.

Based on sector studies<sup>3</sup> and expert opinion, moreover, the potential reduction of domestic transport costs may not be fully enjoyed by the intended beneficiaries without addressing the structure of the road haulage market, including possible policies and practices affecting competition in this sector. This is a critical issue that MCC and MCA-Malawi, MoTPW and NRA need to assess together; MCC will also discuss this with other donors supporting the transport sector in Malawi.

*Implementation risks:* By the GoM's own admission, the country's implementing capacity is low. Provided road projects are successfully identified for investment, the Roads Authority and Ministry of Transport and Public Works will likely need significant support in carrying out the projects to MCC standards, and project implementation may require MCA-Malawi eventually hiring an "employer's representative" (also known as the "Engineer") and an external Project Management Consultant to manage the project. MCC will coordinate closely with the GoM and other donors currently working in the sector in reaching a decision on this matter.

*Level of preparedness:* There are no completed and current feasibility studies or environmental impact assessments<sup>4</sup> for the roads proposed for upgrade; therefore, substantial project preparation work is required prior to a compact investment decision. Of particular concern is the issue of resettlement, which based on initial field visits is expected to be significant given the proposed design criteria and right-of-way (18m ROW either side of center). The Concept Paper timeline significantly underestimates the potential time required to prepare and implement the Resettlement Action Plans (RAPs), while the budget does not include any allocation for resettlement, project administration, monitoring and evaluation, and other associated MCC-required project costs. In order to make a final investment decision in mid 2010, MCC would need key technical and financial information from a feasibility study. The process of planning and procuring an integrated feasibility study/EIA is approximately 150 days and the consulting assignment itself typically takes up to an additional 150 days. So, it is critical that we identify three – five road segments that have a high likelihood of satisfying MCC due diligence criteria, and that procurement of this work then begin immediately.

*Sustainability:* Overall, MCC found that the feeder roads project requires a great deal of further analysis and development on issues of financial and institutional sustainability. Road maintenance, in particular, has historically been an issue for the sector and the GoM has struggled to clear its maintenance backlog in the past. The Ministry of Finance has reported that the fuel levy used to fund road maintenance has been increased by over 100% and the GoM has started moving toward a performance-based routine and periodic maintenance. MCC will need to due diligence the Road Fund, its cost recovery, and the history of road maintenance funding in Malawi. MCC also noted that the distribution of roles and responsibilities for road maintenance

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<sup>3</sup> The following are some of the studies consulted: Somkik Lall, Hyoung Wang and Thomas Munthali, "Infrastructure Investment in Malawi: Insights from a Spatial Analysis," Malawi Country Economic Memorandum, Volume II Background Papers, 2008. "Competition Issues in the Transport Sector in Malawi: Passenger Services and Road Haulage Draft Report," submitted to the Malawi Competition and Fair Trading Commission by TAG Consulting Economists, October 2007. "Malawi Transport Cost Study," submitted to Ministry of Transport and Public Works, International Bank for Reconstruction and Development, Road Maintenance and Rehabilitation Project IDA Credit 3239 MAI, by TERA International Group September 30, 2004.

<sup>4</sup> There was an EIA done for the Monkey Bay Road in 2005, but it will likely need to be updated.

amongst the Roads Authority and national and district governments has been vague and problematic in the past.

*Institutional and policy reforms:* Apart from some capacity-building for a transport regulator, the Concept Paper lacked analysis of institutional and policy issues identified in previous studies<sup>5</sup> such as the structure of the transport market, possible anti-trust/cartel behavior, road asset preservation (axle load control), licensing and permitting, possible transport sector policies restricting entry and competition, hidden barriers to trade (road/custom checkpoints), inadequate institutional arrangements for ensuring sector performance and financial sustainability, and maintenance of transport assets in the pricing of transport services. The World Bank's recent study on landlocked countries has shown that such factors have a far greater impact on transport costs than does road condition. Recent sector studies, such as the draft World Bank Country Economic Memorandum (jointly prepared with MCC, African Development Bank, and DfID) in Malawi also validate these assertions and indicate that the market / ownership structure of the trucking industry is perhaps a significant contributor to high import costs and domestic transport rates.<sup>6</sup> The report notes that "average unit transport price (per ton, per km) is 228.4 kwacha from rural areas to the country's main cities – in comparison transport prices range between 10-12 kwacha per ton per km on routes linking the country to international markets." The MoTPW has recently indicated that Malawi is in discussions at the Southern Africa Development Community (SADC) level to liberalize the sector and allow for the free movement of trucks within SADC countries. The GOM is also introducing new legislation to Parliament for the creation of an independent Road Safety and Traffic authorities. These policy changes require further diligence by MCC and dialogue with MCA-Malawi, MoTPW, MoF and other major stakeholders, including other donors supporting the sector. MCC may link progress with or implementation of the above policies to MCC funding in the transport sector.

*Environmental and social safeguards:* Based on an initial site visit to a portion of the proposed roads, the primary areas of concern include: resettlement and land acquisition, road/rail safety, HIV/AIDS, and other common issues concerning drainage and sediment control, borrow areas, and the protection of sensitive ecosystems. While some of these issues were identified, the potential significance, cost, and risk of environmental and social issues are generally understated and not well described in the Concept Paper, particularly with respect to resettlement and road safety. Clearing the right-of-way to accommodate the proposed upgrading and rehabilitation of roads will undoubtedly affect many small subsistence farmers, as well as owners of small stores and other structures that have encroached in the ROW. Appropriate design and implementation options will need to be examined to minimize land takings. Road safety is another important concern given the high levels of pedestrian and non-motorized traffic along the proposed roads, and the proximity of small shops, schools, crops, and other social services along the road. In addition, HIV/AIDs must also be carefully considered in any civil works project given Malawi's 14% prevalence rate. MCC expects to work closely with PEPFAR to assure appropriate HIV/AIDS risk mitigation and management plans are put in place.

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<sup>5</sup> See footnote number 5.

<sup>6</sup> Somkik Lall, Hyoung Wang and Thomas Munthali, "Infrastructure Investment in Malawi: Insights from a Spatial Analysis," Malawi Country Economic Memorandum, Volume II Background Papers, 2008.

### 3) Governance

#### Overall Assessment

MCC has decided not to proceed with further development of the proposed governance investments as a stand-alone project given that the Investment Committee did not find the stated economic rationale for activities persuasive, costs were deemed exceptionally high, and the number of sub-projects would create significant implementation challenges. As stated earlier, MCC *will* support further design of targeted investments in public financial management that could strengthen fiscal capacity during compact implementation and enhance the sustainability of MCC's investments.

#### **PROPOSED USE OF FUNDING UNDER SECTION 609(G) OF THE MILLENNIUM CHALLENGE ACT**

MCC will use program funding under section 609(g) to assist the GoM with the following compact development activities:

- Technical feasibility studies;
- Economic analysis and data / information gathering;
- Analyses of institutional capacity, sector policies, and legal and regulatory issues;
- Environmental and social assessments;
- Training; and
- Some detailed project design.

These activities include:

Description	Estimated Date of RFP Launch	Party Responsible for Contract Management	Cost (US\$ '000)
<b>Energy Project:</b>			
Technical Feasibility Studies and EIA, inc for PPP/OBA	Q4FY09	MCC	2,800
Power Sector Master Plan (subject to funds available for feasibility study)	Q2FY10	GOM	1,200
<b>Cross-cutting Natural Resource Management (NRM) Components:</b>			
NRM Technical Assistance, Catchment Study, and Weed Harvester EIA	Q1FY10	MCC	750
<b>Transport Project [contingent on IC decision in September 2009]:</b>			
Technical Feasibility, EIA and Detailed Design	Q1FY10	MCC/MCA	2,500
<b>Cross-cutting Public Financial Management Investments</b>	Q1FY10	MCC/USAID	300
<b>Monitoring and Evaluation Support:</b>			
Enterprise Census, Poverty Surveys, Data Quality Review	During CIF Period		1,450
<b>Implementation Start- up Support:</b>			
Procurement Agent	Q2FY10		1,000
Fiscal Agent	Q2FY10		1,500
Accountable Entity Start-up	Q3FY10		1,500
Procurement Training	Completed	MCC	1,200
Project Management Training	Q4FY09	MCC	300
Monitoring and Evaluation Training	Q4FY09	MCC	300
<b>TOTAL</b>			<b>14,800</b>

MCC also will provide funding for compact implementation start-up support. These preparations will include:

- Initial funding for the procurement advisor/agent and fiscal agent contracts, to the extent necessary;
- Funding for advisory support to help define and coordinate design for impact evaluations; and
- Initial funding for the establishment and staffing of the accountable entity, to accelerate implementation planning and start-up activities prior to signing and thereby support a more seamless transition from development to implementation.

## NEXT STEPS

During the July 2009 MCC mission to Malawi, MCC and MCA-Malawi will focus on the following objectives to further compact development:

- Present the results of the Investment Committee review to high-level GoM officials.

- Discuss key policy issues that must be addressed in each sector and the timeline for addressing these issues.
- Conduct further diligence on the proposed feeder roads to provide MCC's Investment Committee additional information for their investment decision in September 2009.
- Gather and collect additional data / information on the proposed sector and potential beneficiaries.
- Refine other projects and key milestones of project development.
- Visit project sites.
- Refine the 609(g) budget.
- Determine human resources needed by MCA-Malawi for the remainder of the compact development period, particularly in regards to an NRM specialist and social specialist.
- Continue donor discussions on the energy and transport sectors.
- Continue capacity assessment of potential implementing entities.
- Discuss issues related to procurement training.

Pending the successful attainment of key policy and project development milestones, MCC is optimistic that a FY10 compact signing can be achieved. See Annex II for a notional timeline.

## Annex II: Notional Compact Development Timeline and Resource Schedule

Malawi Transaction: Notional Timeline and Resource Schedule (June 2009 -- August 2010)

