MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

CONGRESSIONAL NOTIFICATION TRANSMITTAL SHEET

We wish to inform you that the Millennium Challenge Corporation plans to negotiate a Millennium Challenge Compact with the Government of Nepal.

If you or your staff would like to arrange a meeting to discuss the proposed negotiations with the Government of Nepal, please contact me at (202) 521-2695. This notification is being sent to the Congress on May 30, 2017 and negotiations with Nepal may be started on or after June 14, 2017.

Sincerely,

/s/

James Mazzarella
Vice President (Acting)
Congressional and Public Affairs

Enclosure: As stated

MILLENNIUM CHALLENGE CORPORATION
CONGRESSIONAL NOTIFICATION

May 30, 2017

Pursuant to (i) the heading "Millennium Challenge Corporation (Including Transfer of Funds)" of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2010; (ii) the heading "Millennium Challenge Corporation" of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2012; (iii) the heading "Millennium Challenge Corporation" of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2012, as carried forward by the Consolidated and Further Continuing Appropriations Act, 2013; (iv) the heading "Millennium Challenge Corporation" of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2015; (v) the heading “Millennium Challenge Corporation” of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2016; (vi) the heading “Millennium Challenge Corporation” of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2017; and section 610(a) of the Millennium Challenge Act of 2003, as amended, this notification is (1) to advise you that the Millennium Challenge Corporation (MCC) intends to start negotiations with the Government of Nepal for a Millennium Challenge Compact; (2) to initiate Congressional consultation before the start of negotiations; and (3) to identify the objectives and mechanisms (attached) to be used for the negotiations of the Compact.

OBJECTIVES AND MECHANISMS TO BE USED
FOR THE NEGOTIATION OF THE PROPOSED NEPAL COMPACT

Overview

The Government of Nepal has prepared a proposal for an MCC compact to address two of the country's binding constraints to economic growth: the inadequate supply of electricity and the high cost of transportation.

Background and Context

Nepal's economic growth, labor productivity, and gross domestic product per capita are among the lowest in South Asia. A decade of civil and political unrest during its ten-year civil war, from 1996-2006, has shaped the social, economic, and political landscape of the country, along with the impacts of the devastating earthquakes in 2015 that killed nearly 9,000 people and pushed an additional million of its people below the poverty line, delivering shockwaves through the Nepali economy. Each year, almost half a million people leave the country for economic opportunities elsewhere.

Nepal's proposed compact is designed to address the underlying causes of the two identified constraints to growth, the inadequate supply of electricity and the high cost of transportation. Nepal historically has suffered from the worst electricity shortages in South Asia, and new investment in Nepal's electricity sector is critical to achieve economic growth. Only half of the demand for electricity can be met by the nation's grid, which has resulted in load-shedding of up to 18 hours a day during the dry winter months when hydropower generation is low. The constraints analysis found that the low availability of electricity creates significant costs for businesses that run generators on expensive imported fuel. The availability of electricity is further reduced by Nepal's inability to import power when it is needed and the high level of losses in transmission and distribution.

Like the power sector, the performance of the road transport sector has suffered from Nepal's past political instability and inadequate investment. A combination of weak planning, poor project execution, political interference and patronage, and diversion of financial resources away from the sector have contributed to poor road quality, inefficient customs and border enforcement, an inefficient trucking industry, and poor road coverage. The Government of Nepal understands that investments in this sector are needed to reduce transportation costs and promote economic activity and growth.

Program Overview and Budget

After MCC selected Nepal for threshold program assistance in December 2011, MCC and the Government of Nepal undertook a study of Nepal's constraints to growth and together prepared a threshold program based on the results. Given Nepal's strong performance on its MCC policy indicator scorecard, however, in December 2014 before the threshold program was finalized, MCC's Board of Directors selected Nepal as eligible to develop a compact. MCC and the Government of Nepal used the analytic data already completed to develop the current compact proposal.

Based on the findings of this economic analysis, MCC and the Government of Nepal chose to focus on two constraints best suited for MCC's investment, the inadequate supply of electricity

and the high cost of transportation. The compact proposal seeks to address the selected constraints by investing in two projects: the **Electricity Transmission Project** (ETP) and the **Road Maintenance Project** (RMP).

- Given other efforts already underway in the generation and distribution parts of the power sector value chain, Nepal is targeting transmission as the underinvested portion of the value chain that is suited for MCC investment. If approved, the ETP would add approximately 300 kilometers to the high-voltage transmission backbone inside Nepal, complete the Nepal portion of the second cross-border transmission line with India for increased electricity trade, and provide technical assistance activities aimed at improving the sustainability of the power sector.
- The RMP would focus on improving Nepal's road maintenance regime and include an incentive-matching fund to maintain up to 300 kilometers of roads over five road segments while increasing the Nepal government's budget for road maintenance.

The following summary describes the components of Nepal's compact proposal. The preliminary compact budget and expected impacts are based on initial due diligence and project appraisal, and are subject to change following compact negotiations. The anticipated MCC investment for the compact going into negotiations is estimated to be approximately $498 million, and the Government of Nepal is expected to contribute $130 million toward the compact objectives.

Table 1: Nepal Compact Budget

Component	Total (in millions of U.S. dollars)
1. Electricity Transmission Project	
1.1 Transmission Lines Activity	311.5
1.2 Substation Activity	142.5
1.3 Power Sector Technical Assistance Activity	24.6
1.4 Project Management Activity	38.8
Subtotal	**517.4**
2. Roads Maintenance Project	
2.1 Technical Assistance Road Maintenance Reform	9.2
2.2 Strategic Road Maintenance Works	45.1
Subtotal	**54.3**
3. Monitoring and Evaluation	
3.1 Monitoring and Evaluation Activities	9.4
Subtotal	**9.4**
4. Program Administration and Oversight	
4.1 Program Administration	30.3
4.2 Fiscal Agent	7.9
4.3 Procurement Agent	7.9
4.4 Audits	0.8
Subtotal	**46.9**
Total Program Investment	**628.0**
Estimated MCC Contribution	**498.0**
Government of Nepal Contribution	130.0

Proposed Projects

Electricity Transmission Project (ETP):
The objective of the ETP is to increase per capita electricity consumption, thereby spurring economic activity and growth by improving the availability and reliability of electricity supply in Nepal's power grid. The ETP is made up of four activities:

- Transmission Lines Activity. If approved, this activity is planned to focus on the construction of approximately 300 kilometers of high voltage transmission lines in Nepal—equivalent to almost one-third of the length of the country. Most of the proposed transmission lines traverse hilly terrain, starting from close to Kathmandu Valley and moving to the west and then southwest to the Indian border. The particular lines were selected following careful analyses and feasibility studies that weighed their technical and economic merit, their criticality in meeting Nepal's medium and longer term electricity supply goals, and their consistency with Nepal's domestic and cross border transmission investment plans.

To the extent possible, the transmission line route was selected to minimize impact on people and sensitive geographic areas, such as national parks. However, to further mitigate potential negative social impacts from construction of the transmission lines, and to gain acceptance from affected communities, the ETP contemplates funding for certain community benefit-sharing projects. Potential projects may include rural electrification through off-grid solutions or other community empowerment programs.

- Substations Activity. This activity is complementary to the Transmission Lines Activity. The proposal contemplates constructing three substations, which are electricity pooling and transforming hubs to consolidate electricity from multiple power sources. The substations increase or decrease transmitted voltages for further transmission or distribution to demand centers. In combination with the transmission lines, these substations would help evacuate and transmit power collected from three major river basins where large hydropower projects are under construction by investors, many of whom are private. The substation at a town near Butwal would be the starting point for the transmission line going to the Indian border to connect with the Indian power grid.

- Power Sector Technical Assistance Activity. This activity would focus on strengthening the proposed power sector regulator (the Nepal Electricity Regulatory Commission (NERC)) to help bring transparency, efficiency and competition into the power sector. Nepal is seeking to embed experts within NERC to improve the skills of this start up agency in rule-making, dispute resolution, and economic and technical regulation. This activity would also focus on helping the Nepal Electricity Authority (NEA) improve its transmission business so that when the Government of Nepal is ready to create an independent transmission company, the NEA transmission business has the tools and skills to become an effective transmission and system operator. This effort is planned to focus on establishing within the NEA a regulatory cost recovery system, improved grid operations, and better power system planning.

- Program Management and Technical Oversight Activity. This activity is designed to complement the Transmission Lines and Substation Activities. To successfully implement the proposed infrastructure investments while complying with MCC's technical, environmental and social standards, this activity would support project management, environmental and social impact assessment, and engineering and technical supervision.

Road Maintenance Project (RMP):
The objective of the RMP is to avoid increases in transportation costs across Nepal's strategic road network by preventing future deterioration of maintained roads and improving Nepal's road maintenance regime. This project has two activities, as described below:

- Technical Assistance Activity. If approved, this activity is planned to provide training and capacity building for the Department of Roads in (1) improved data collection and techniques; (2) preparation of appropriate road maintenance plans and cost estimates; (3) improved prioritization of periodic maintenance; (4) improved contracting and contracting management; and (5) improved project management.

- Periodic Road Maintenance Activity. This activity seeks to complement and build upon the

Technical Assistance Activity. To incentivize additional government spending on road maintenance, the activity would establish a matching fund to provide $2 for every $1 the Government of Nepal spends above its current average annual amount for road maintenance, up to a total of $15 million annually for three years (focused on periodic road maintenance works). An initial set of maintenance projects on some 300 kilometers, out of 2,000 kilometers of the strategic road network proposed by the Government of Nepal, have been identified during due diligence through the use of the Highway Development and Maintenance Management Model.

Economic Analysis

The proposed Electricity Transmission Project has an estimated economic rate of return of 12 percent. The investment in Nepal's transmission system is expected to affect all grid-connected consumers. The MCC investment, therefore, would be expected to impact at least the 72 percent of Nepali households currently believed to be connected to the grid. With the projected population in 2024 of 31.5 million people, an estimated 23 million individual beneficiaries living in five million beneficiary households are expected to benefit from this proposal. Fifty-two percent of the potential beneficiaries are estimated to be female.

The estimated economic rate of return for the Road Maintenance Project is 29 percent. The five roads proposed by the Nepali for periodic maintenance under the compact cross through 52 village development committees (VDCs) and municipalities in Nepal. The entire population of these 52 VDCs and municipalities, estimated to be approximately 924,000 people in approximately 205,000 households, is expected to benefit from the road maintenance projects.

We assume some overlap in the beneficiaries of the two proposed projects and ultimately expect the compact to positively benefit a total of approximately 23 million beneficiaries.

Policy Reforms and the Compact Proposal

In order to ensure sustainability, MCC plans to require certain conditions to compact funding regarding key issues. For example, given the proposed compact's focus and the clear need within Nepal for a second cross-border transmission connection with India, MCC intends to require, as a condition to entry into force of the compact, evidence of technical, operational and financial arrangements for construction of a cross-border line in India. This requirement is expected to be further strengthened in MCC's conditions on future disbursements of compact funding.

Any final proposed compact is expected to include several key reform elements, particularly in the technical assistance activities for each project. The Power Sector Technical Assistance Activity is planned to include conditions focused on helping Nepal create a transparent, competitive and efficient electricity market. MCC believes creation of the NERC will help address the current lack of an independent and capable regulator, which is essential for maintaining open, non-discriminatory access to a transmission network with transparent pricing and clear rules of engagement for all power market operators, particularly investors in generation projects. Given the size of the infrastructure investment, MCC proposes to increase the utility's planning, operations and cost recovery mechanisms to help ensure that the benefits of the proposed compact investment are sustainable. Strengthening the utility's transmission business now should ensure its viability in the future if Nepal decides to spin off or merge that business with an independent

transmission company. MCC intends to condition any funding for the Power Sector Technical Assistance Activity on passage of a bill to establish the NERC by the Federal Parliament of Nepal.

Similarly, for the Technical Assistance Activity for the RMP, MCC plans to provide funding for maintenance works only if the Government of Nepal increases its own historically low spending levels. The compact is expected to incentivize the Government of Nepal to increase its spending for road maintenance significantly by making MCC funding available only in proportion to the increase in Nepali government spending.