



HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

CABO VERDE

Climate Policy Assessment

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High-Level Summary Technical Assistance Report

Fiscal Affairs Department

Cabo Verde: Climate Policy Assessment

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The *High-Level Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: Cabo Verde faces development challenges from multiple structural factors, including insularity, territorial discontinuity, fragility of ecosystems, and scarcity of natural resources, namely water and arable land. Climate change implications are amplifying these challenges. As an island extension of the arid Sahel zone, Cabo Verde faces severe water shortage, which the country addresses more and more through energy intensive desalination, using electricity produced largely by thermal power plants, which depend entirely on imported fossil fuels. The resulting high energy prices directly impact the cost of water production. In conjunction with climate change induced aridity, the energy-water-climate nexus presents the core development challenge for the country.

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Background

The government of Cabo Verde has sought to undertake a Climate Policy Assessment that could aid the development of strong and transformative reform measures. The mission conducted a comprehensive climate policy diagnostic, covering climate adaptation and mitigation policies, as well as enabling institutions to support climate investment. The diagnostic covered climate fiscal policy aspects that go beyond—and supplement—the measures considered in the 2023 Climate Public Investment Management Assessment (C-PIMA). Cabo Verde faces development challenges from multiple structural factors, including insularity, territorial discontinuity, fragility of ecosystems, and scarcity of natural resources, namely water and arable land. The resulting reliance on external provision of key resources, including food and energy, exposes the country to global market fluctuations, which affect especially the vulnerable and poor. Climate change implications are amplifying these development challenges. Cabo Verde has suffered from several climate hazards events, including droughts and floods and its geography and the concentration of activity along the seashore puts the economy and the population at risk from tropical storms and sea level rise. The government of Cabo Verde is working towards identifying and implementing mitigation and adaptation policies to address the impact of climate change, increase resilience, and improve the country's ability to prepare for and respond to natural disasters. Water scarcity is more and more addressed through energy intensive desalination, using electricity produced largely by thermal power plants, which depend entirely on imported fossil fuels. The resulting high energy prices directly impact the cost of water production, building an energy-water-climate nexus. However, solar and wind energy, for which Cabo Verde has ample potential could provide a cheaper source of energy. While the country's contribution to global greenhouse gas emissions is negligible, the transition to renewable energy is key for both, addressing development challenges and preparing for the implications of climate change. Thus, climate change does not change the policy areas that are at the center of the governments' attention but reinforces the need for addressing them and shapes the options for policy design.

Summary of Findings

The country's national development strategy (PEDS) II sets the policy priorities. These are reflected in the Nationally Defined Contribution (NDC) and its National Adaptation Plan (NAP), which Cabo Verde submitted under the UNFCCC as a signatory to the Paris Agreement. While the NDC and NAP lay out broad policy intentions, sectors define their detailed objectives and policy measures in sectoral plans. For key sectors, including energy and water these plans are currently being updated to reflect important new developments regarding demand and supply for energy and water. Given the interdependence of these two sectors, the coordination of sectoral plans, which remains a challenge, would need to be improved. While the energy sector is managed at the national level and the water sector at the municipal level, both sectors face similar structural challenges. Energy and water tariffs have not covered the cost-of-service provision and the publicly owned utilities accumulated losses which resulted in a financially nonsustainable situation for several entities, including the national electricity company and several municipal water companies, resulting in a low-quality low-tariff cycle. Important reforms are ongoing in both sectors to address these challenges. IMF | Summary Technical Assistance Report – Cabo Verde

Climate Policy Assessment | 4 To enhance the viability and performance of the energy sector, ELECTRA, the national electricity and water company separated the electricity and water business and started the unbundling of electricity services. The latter will be an important step towards creating a transparent and competitive environment conducive for private sector investment in energy production. The pace for the onboarding of renewable energy is constrained by the grid infrastructure. Without further investment Cabo Verde's capacity for absorbing renewable energy is limited and will not allow the country to reach the 2030 objective of 54 percent. Important public infrastructure investment, including in storage, will be required to include substantial more renewables in the energy mix. The coordination required to IMF | Summary Technical Assistance Report – Cabo Verde Climate Policy Assessment | 4 synchronize the strengthening of grid infrastructure and the expansion of renewable energy capacity is exacerbated by the segregation of the grids, which need to be managed on an island-by-island basis. Operations of the water sector have been consolidated, moving from a municipality-by-municipality approach to a multi-municipality island-by-island setup. Operators are appointed for each island and are responsible for the operation of the distribution system. Several important operators, including the largest one, which is responsible for Santiago Island are running considerable technical and commercial losses. In combination with a tariff structure that does not allow to recover the full cost of service provision, these losses are leaving the operators in a financially unsustainable situation.

Summary of Recommendations

It will be important that the publicly owned transmission and distribution companies in the electricity sector and the operators in the water sector are put on financially sound footing and managed efficiently, to make them a reliable partner for private sector investors in the sectors, which will have to rely on the public sector entity as the single buyer and off taker. In the electricity sector, the full legal unbundling of the entities will be an important step in the process. Additionally, it is key for the government to invest in grid capacity creating storage to reap the benefits of cleaner and cheaper renewable energy. In the water sector, addressing the technical losses will require substantial investment in distribution infrastructure. Identifying and transparently reporting on the cost of the losses and their sources, together with a credible loss reduction strategy, would allow to motivate public investment in the sector and provide a basis for potential future adjustments in water tariffs. Operators in the energy and water sector should be compensated for the cost-of-service provision either through the tariff, which might require adjusting electricity and/or water tariffs, or through a combination of the tariff and a government transfer from the budget in case the regulated tariff remains below cost recovery, making the service a quasi-fiscal activity. Putting the sector on a sound economic footing and allowing the operators to run their organizations under commercial-like terms, can enhance efficiency and create transparency and competition, providing a conducive environment for private investment. Adverse implications of any tariff adjustment on the vulnerable or poor should be compensated through targeted transfers from the social safety net. To this end, the design of the social safety net could be strengthened by expanding the coverage of the unified social register. The overall cost to the government of introducing higher tariffs while compensating the vulnerable and poor can be neutral while improving the situation of the households that receive compensation. Compensation measures can also be designed to compensate the vulnerable and poor for the impact of the tariff increase while providing extra revenues to the government. A careful design of such a reform and the implementation of a well-designed communication strategy is critical for ensuring

the full benefit while ensuring social and political support for the reform. The government faces some challenges in implementing efficient structures for coordinating and managing climate change related policies and for disaster risk management. Both functions require IMF | Summary Technical Assistance Report – Cabo Verde Climate Policy Assessment | 5 strong leadership and cross government coordination, which is best provided by a coordination council at the level of the Council of Ministers or under the Prime Minister’s office. This councils could also promote the government wide awareness of the implications of climate change and for the need to build resilience to better manage these challenges. A key condition for an effective preparation for climate change implications is to disseminate information regarding what to expect from climate change, including by creating and sharing climate scenarios relevant to Cabo Verde and hazard vulnerability maps that include potential climate related hazards consistent with the climate scenarios. Overall, the government has taken important steps towards sector-by-sector planning, including by taking into account some aspects of climate change. More would need to be done to ensure that climate change implications are fully embraced and to foster cross sector consistency of policy measures in general and related to the long-term vision needed in light of climate change.