



Report and Recommendation of the President to the Board of Directors

Project Number: 47015-001
April 2014

Proposed Programmatic Approach and Policy- Based Loan for Subprogram 1 Islamic Republic of Pakistan: Sustainable Energy Sector Reform Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 25 March 2014)

Currency unit – Pakistan rupee/s (PRe/PRs)

PRe1.00 = \$0.0102

\$1.00 = PRs97.8333

ABBREVIATIONS

ADB	–	Asian Development Bank
COBP	–	country operations business plan
CPPA	–	Central Power Purchasing Agency
CPS	–	country partnership strategy
DISCO	–	distribution company
ECC	–	Economic Coordination Committee
EFF	–	extended fund facility
ESRP	–	Energy Sector Restructuring Program
GDP	–	gross domestic product
GENCO	–	generation company
IMF	–	International Monetary Fund
IPP	–	independent power producer
kWh	–	kilowatt-hour
NEPRA	–	National Electric Power Regulatory Authority
PCU	–	program coordination unit
SDR	–	special drawing right

NOTES

- (i) The fiscal year (FY) of the Government of Pakistan ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2013 ends on 30 June 2013.
- (ii) In this report, “\$” refers to US dollars.

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PROGRAM AT A GLANCE

1. Project Name: Sustainable Energy Sector Reform Program		2. Project Number: 47015-001	
3. Country: Pakistan		4. Department/Division: Central and West Asia Department/Energy Division	
5. Sector Classification:			
	Sectors	Primary	Subsectors
	Energy	√	Energy sector development
6. Thematic Classification:			
	Themes	Primary	Subthemes
	Economic growth	√	Promoting macroeconomic stability
	Private sector development		A conducive policy and institutional environment
	Governance		Public administration (national)
	Capacity development		Institutional development
6a. Climate Change Impact No Climate Change Indicator available.		6b. Gender Mainstreaming	
		Gender equity theme (GEN)	
		Effective gender mainstreaming (EGM)	
		Some gender elements (SGE)	
		No gender elements (NGE)	√
7. Targeting Classification:		8. Location Impact:	
	Targeted Intervention		
General Intervention	Geographic dimensions of inclusive growth	Millennium development goals	Income poverty at household level
√			
		National	High
9. Project Risk Categorization: Complex			
10. Safeguards Categorization:			
Environment		B	
Involuntary resettlement		C	
Indigenous peoples		C	
11. ADB Financing:			
	Sovereign/Nonsovereign	Modality	Source
	Sovereign	Program loan	Asian Development Fund
	Total		400.0
12. Cofinancing:			
	Financier	Category	Amount (\$ Million)
	World Bank		600.0
	Total		600.0
13. Counterpart Financing: No Counterpart Financing available.			
14. Aid Effectiveness:			
Parallel project implementation unit		No	
Program-based approach		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Sustainable Energy Sector Reform Program; and (ii) a proposed policy-based loan to the Islamic Republic of Pakistan for subprogram 1 of the Sustainable Energy Sector Reform Program.

2. The proposed program aims to support the 2013 National Power Policy of the Government of Pakistan to make the energy sector affordable, reliable, sustainable, and secure to support the country's economic growth.¹ The government approved the power policy with the goal of alleviating the chronic energy crisis that has crippled the industries and caused social unrest. The government agreed with the International Monetary Fund (IMF), under the extended fund facility (EFF), to reduce the energy sector's burden on the annual state budget and its negative impact on economic growth.² The government has met the requirements for the first and second IMF reviews.³ The program is fully coordinated with the EFF. Based on the findings and lessons from previous interventions, the government needs support to realize and sustain the reforms set out in the power policy.

3. The proposed program takes a chronological approach over 5 years, with a subprogram targeted for each year and matched to the annual budget schedule. Long-term engagement is necessary because the reforms are multidimensional and through their cumulative effect, require a number of years to yield optimal results.

II. THE PROGRAM

A. Rationale

4. Pakistan's economic growth slowed markedly in 2013, resulting in a 5-year average of 3%, which is well below the 7% annual growth necessary for sufficient employment creation to absorb the new entrants into the labor force. The chronic power shortage is estimated to have slowed gross domestic product (GDP) growth by at least 2 percentage points per year and is deemed to be the major cause of a decline in large-scale manufacturing, which grew by just 1.2% in 2012 and 2.8% in 2013. Without reliable power, factories are not able to deliver orders on time and have lost contracts. Textile exports, which account for more than 50% of goods export receipts, have only increased marginally since 2010. The steady deterioration of power availability has also hurt business confidence. Private investment has decreased by 7.5% since 2008. Power sector subsidies remain high at 1.8% of GDP, or \$3.8 billion, despite a 160% increase in power tariffs since 2008.⁴ Power sector subsidies combined with low tax revenues are a significant contributor to the government's weak fiscal position. High fiscal deficits (8% of GDP in FY2013) led to more government borrowing, mainly from the domestic banking system, and elevated public debt (62.7% of GDP in FY2013). The Fiscal Responsibility and Debt Limitation Act 2005 requires the government to reduce the public debt-to-GDP ratio to 60% by June 2013 (i.e., the end of FY2013) and maintain that ratio at below 60% from July 2013

¹ On 27 July 2013, the Council of Common Interests approved the National Power Policy to support current and future energy needs of the country. <http://www.ppib.gov.pk/National%20Power%20Policy%202013.pdf>

² On 4 September 2013, the International Monetary Fund board approved a \$6.7 billion, 36-month program under the EFF that aims to bring down inflation and reduce the fiscal deficit to more sustainable levels. <http://www.imf.org/external/pubs/ft/scr/2013/cr13287.pdf>

³ The first review was completed on 8 November 2013; the second review was completed on 10 February 2014. <http://www.imf.org/external/pubs/ft/scr/2014/cr1401.pdf>, <https://www.imf.org/external/pubs/ft/scr/2014/cr1490.pdf>

⁴ The average tariff increased from PRs4.26 per kilowatt-hour (kWh) to PRs8.81 per kWh in May 2012, and further to PRs11.11 per kWh in October 2013. In the same period, the consumer price index rose by 96%.

onward. The public debt-to-GDP ratio was 62.7% in FY2013, mainly owing to the actual deficit being higher than projected.⁵ The government expects that the ratio will be 61.4% for FY2014 and will take measures to maintain it below 60% from FY2015 onwards.⁶ The continued pursuit of tax and structural reforms to achieve fiscal consolidation, underpinned by the IMF program and support from ADB and other development partners, is expected to strengthen the fiscal position. Fiscal performance was on track in the second quarter of FY2014.⁷ With strong fiscal adjustment, public debt is expected to decline gradually (footnote 6).

5. Reforms in Pakistan's power sector have been ongoing since 1992. However, the pace has been slow and the expected efficiencies have yet to materialize. The unbundling and corporatization of the Water and Power Development Authority into nine regional power distribution companies (DISCOs), four thermal power generation companies (GENCOs), a transmission company licensed as a single buyer and seller of electricity, and the hydropower plants still retained by the Water and Power Development Authority was accomplished, but all entities are still fully owned by the government. Karachi Electric Supply Company has been privatized. Privately owned independent power producers (IPPs) generate 56% of the country's power. The National Electric Power Regulatory Authority (NEPRA) determines tariffs, issues licenses, and regulates the sector. Around two-thirds of the population has access to grid electricity. The consumption of electricity has remained constrained and relatively static at about 70 terawatts per year since 2007. The key issues are described below.

6. **Tariffs and subsidies.** The government does not pass on the total cost to the electricity customers and provides subsidies to the DISCOs for the difference between the tariff billed to the customers and the cost-recovery tariff determined by NEPRA. The country's dwindling natural gas reserves and stagnant hydropower generation capacity, which used to be the primary sources of electricity, have resulted in greater use of imported fuel oil.⁸ Power generation costs have increased significantly due to higher reliance on imported fuel oil, increasing the demand–supply gap to one-third of demand in 2013, and worsening the shortage. Strong efforts are needed to increase domestic gas supply, explore the sizable domestic coalfields, and develop hydropower, which all will help lower power generation costs.

7. The difference between the customer tariff and the cost-recovery tariff, and the delay in determining and applying the cost-recovery tariff and paying the subsidies have led to (i) substantial and costly payment arrears to fuel suppliers and IPPs; (ii) decreased efficiency due to lack of funds for maintenance and augmentation of equipment; (iii) critically low working capital of the public and private sectors, leading to payment arrears; and (iv) concerns by private investors and their financiers about the creditworthiness of the power sector.

8. **Sector performance and private sector participation.** In 2012, electricity distribution and transmission losses reached 23% and collection amounted to 86% of total billing, compared with NEPRA's targets for losses (16%) and collection (100%). Gas distribution losses totaled 11% against 4.5% allowed by the Oil and Gas Regulatory Authority. Public companies dominate the energy sector and losses in efficiency have remained largely unchanged since 2008. Private

⁵ Government of Pakistan, Ministry of Finance. 2014. *Debt Policy Statement 2013–2014*. Islamabad.

⁶ The International Monetary Fund's estimates are 64% for FY2014 with the ratio going down below 60% in FY 2018. IMF. 2014. *Pakistan: Second Review under the Extended Arrangement and Request for Waivers of Nonobservance of Performance Criteria*. Washington, DC.

⁷ IMF. 2014. *Statement at the Conclusion of an IMF Staff Mission on Pakistan*. Press Release No. 14/46, Washington, DC.

⁸ Hydropower's share declined from 72% (1980) to 32% (2012). The share of gas in the thermal generation fuel mix has fallen from 56% (2006) to 44% (2011), while heavy fuel oil increased from 42% to 54% during the same period.

sector customers' unpaid bills have increased by 359% during the same period.⁹ The poor performance of the public sector companies caused further accumulation of unpaid electricity generation bills. In 2013, the government injected \$3.8 billion in equity into the DISCOs to clear these losses. On the demand side, inefficient industrial processes and equipment, household and commercial appliances, and buildings are all sources of energy wastage. Private participation in the energy sector is curtailed because of chronic concern about payment to power suppliers, unclear investment policies and guidelines, and lack of transparent payment practices. The Central Power Purchasing Agency (CPPA) was to provide a transparent settlement system and to evolve into a multibuyer and multiseller trading platform for competitive electricity pricing. CPPA's separation from the transmission company is still being implemented, while NEPRA is consulting the public for a model wheeling charge agreement that would simplify procedures for electricity trading. Public sector energy companies have been slated for privatization.

9. **Accountability and transparency.** The lack of transparency in the operation and payment mechanisms has made it difficult to hold public sector companies accountable for their performance. Automatic meters have now been installed at the 11-kilovolt level, allowing real-time monitoring of neighborhood-specific losses. An extension of automatic meters to customers will be needed to prevent overbilling and theft. Since the system lacks funds to pay for the power generated, power suppliers are uncertain about the priority and timing of payment. There were concerns raised on the payments to IPPs not being based on merit.

10. Changes needed for Pakistan's ailing energy sector to become sustainable and reliable cannot be realized overnight. Careful sequencing of policy actions and full implementation of difficult decisions are needed. The program is designed to align each subprogram with targets for each period and thus enable achievement of the desired long-term outcome by the end of the program. Reform progress will be reviewed quarterly, together with the IMF–EFF reviews. Given the sector's dynamic nature and Pakistan's macroeconomic condition, the flexibility imbedded in this modality enables timely action and necessary adjustments to achieve the program's impact and outcome.

11. **ADB assistance.** ADB is the leading partner in the sector and is engaged holistically, supporting energy efficiency, transmission, distribution, cross-border natural gas pipelines, power generation, and renewable energy.¹⁰ The power policy and the proposed program follow the recommendations of the Friends of Democratic Pakistan Energy Sector Task Force, which ADB co-chaired with the government.¹¹ Through similar interventions, such as the Energy Sector Restructuring Program (ESRP), ADB initiated key sector reforms in 2000. Power sector reforms were part of the Accelerating Economic Transformation Program in 2008 and 2009.¹² The lessons from the ESRP are: (i) linking program conditions where ADB has a strong position, (ii) providing extensive long-term support through technical assistance and policy dialogue for difficult reforms, (iii) privatizing state-owned enterprises instead of just unbundling, (iv) reducing

⁹ Receivables owed by private customers totaled \$2.6 billion or 1.14% of GDP in 2013, whereas receivables owed by provincial and federal government customers increased by 7% from 2008 to 2013 and totaled \$1.5 billion or 0.66% of GDP in 2013. See Circular Debt Impact on Power Sector Investment (accessible from the list of linked documents in Appendix 2).

¹⁰ ADB's ongoing portfolio in the energy sector is \$2.6 billion. The total multitranchise financing facility amount is \$2.9 billion. The government has requested new multitranchise financing facilities for transmission and distribution.

¹¹ Membership consists of the government and 26 donors, including the People's Republic of China, France, Germany, Japan, United Kingdom, and United States. Friends of Democratic Pakistan, Energy Sector Task Force. 2010. *Integrated Energy Sector Recovery Report and Plan*. Islamabad.

¹² ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Islamic Republic of Pakistan for the Accelerated Economic Transformation Program*. Manila.

subsidies as a crucial step, (v) staying engaged, and (vi) reducing electricity theft.¹³ The ESRP reform was successful in establishing NEPRA, but did not include or follow on with direct measures to eliminate subsidies or to maintain the cost-recovery tariff. The power sector companies were unbundled under the ESRP, but have not become independent commercial companies and were not privatized. The country assistance program evaluation recommends pursuing structural reforms through sector-specific initiatives using a programmatic approach.

12. **Link to country partnership strategy.** The program is aligned with the priorities of ADB's country partnership strategy (CPS), 2009–2013 for Pakistan—policy reforms and structural transformation in the energy sector.¹⁴ The program is included in the country operations business plan (COBP), 2014–2016 for Pakistan.¹⁵ ADB's forthcoming CPS, 2014–2018 for Pakistan envisages a focus on contributions that will strengthen the energy sector, consistent with ADB priorities such as inclusive growth. The energy sector is a barrier to economic growth, adequate job creation, and macroeconomic sustainability. It will play a central role in the new CPS, supporting energy policy reforms and structural transformation.

B. Impact and Outcome

13. The impact of the program will be a sustainable energy sector that supports economic growth. The outcome will be a reliable, sustainable, and affordable energy system.

C. Outputs

14. The program consists of five annual subprograms that support the government's reform initiatives as outlined in the power policy, and specifically cover medium- to long-term issues in three areas: (i) managing tariff and subsidies with revised and updated policies and guidelines to create a self-sustaining tariff regime, (ii) improving energy sector performance and the market environment to encourage participation by private entities, and (iii) increasing accountability and transparency through public disclosure on the progress of the reforms and the performance of sector participants. The program is expected to encourage investments and provide the basis for dynamic policymaking and regulatory improvements with the objective to make the sector self-sustainable.¹⁶ All 10 policy conditions for subprogram 1 were met by 31 March 2014. Subprogram 1 outputs are as follows:

15. **Output 1: Managing tariffs and subsidies.** The objectives of this output are to have (i) clear policies on tariffs and subsidies targeted at low-income customers, (ii) policy implementation through NEPRA rules and guidelines, (iii) reduction of discretionary policy decisions and lags in tariff approval and implementation, and (iv) limits to power sector arrears. The Economic Coordination Committee (ECC) approved the National Power Tariff and Subsidy Policy Guidelines on 28 January 2014.¹⁷ The guidelines set out the short-, medium- and long-

¹³ The program was rated less than successful, but was considered relevant as support to the economy.

ADB. 2013. *Performance Evaluation Report: Energy Sector Restructuring Program in Pakistan*. Manila.

¹⁴ ADB. 2009. *Country Partnership Strategy: Pakistan, 2009–2013*. Manila. The CPS 2014–2018 for Pakistan is being prepared.

¹⁵ ADB. 2014. *Country Operations Business Plan: Pakistan, 2014–2016*. Manila. Economic Transformation for Growth Program (Energy Sector) is the proposed program's title in the COBP 2014–2016 for Pakistan.

¹⁶ Equipment and infrastructure necessary to improve sector performance are supported by ADB and other donors through project financing.

¹⁷ The ECC is chaired by the Finance Minister and the economics ministers are members. The amendments to Penal Code 1860 and the Code of Criminal Procedures 1898 have been enacted through Presidential ordinance, which will be submitted to the Parliament for ratification (IMF structural benchmark). Utility courts will be established under the amendment. A new electricity act to modernize governance of the sector is being drafted.

term goals on subsidies and tariffs, and the principles of reform in designing new guidelines for NEPRA. The NEPRA determination process, including the introduction of a multiyear tariff mechanism and automatic fuel price adjustments every quarter, will assist the timely application of a full cost-recovery tariff. The DISCOs will be requested to submit periodic investment plans in advance, along with their respective tariff petitions, to fast-track the determination process. Clear third-party access guidelines and tariffs will be fully disclosed and updated. The government will develop a mechanism to monitor and limit the accumulation of unpaid bills to the power generation companies. The government will eliminate subsidies by 2016, except for those to low-income customers who consume up to 200 kilowatt-hours (kWh) of electricity per month. Identification of these customers and subsequent implementation of the subsidy payment scheme will be developed based on a study that reviews alternative payment options as well as existing mechanisms such as the Benazir Income Support Programme. As the government intends to maintain a uniform national tariff, the guidelines establish the principles for tariff equalization via an interregional subsidy. NEPRA's draft guidelines on DISCO tariff determination were posted on its website for public consultation in February 2014.¹⁸ The draft guidelines specify the methodologies, timetable, formula, and procedures for DISCO tariff determination.

16. Output 2: Improving sector performance and market access for private sector participation.¹⁹ Market-oriented reform will be put in place to increase efficiencies of public sector power companies and encourage private sector participation. The objectives are: (i) to reduce losses and improve tariff collection by DISCOs, (ii) improve demand-side efficiency and strengthen energy conservation, (iii) manage generation costs through least-cost plans and ensure their implementation, (iv) increase gas supply and open the market to direct contracting between producers and large consumers, (v) commercialize public sector power companies,²⁰ and (vi) institutionalize CPPA's commercial operations. Both loss reduction and better tariff collection by DISCOs are critical to their performance and sustainability. For subprogram 1, the Ministry of Water and Power instructed four DISCOs to outsource collection to the private sector, and instructed all DISCOs to implement a revenue protection program that will improve collection. A mechanism was submitted and discussed at the Council of Common Interests to automatically deduct overdue provincial government customer electricity bills from the federal government allocation to the provinces. The federal government customers has been informed that bills exceeding 90 days will be automatically deducted from their budget allocations and directly paid to the DISCOs. The government's commitment to reduce generation costs by adjusting the fuel mix will be manifest in the implementation of a long-term, least-cost generation and transmission expansion plan.²¹ For subprogram 1, the government has issued instructions for the least-cost plan to take into account energy security and all associated costs, including social, environmental, and climate change risk mitigation measures. The government will also expedite the implementation of the Petroleum Exploration and Production Policy of 2012 and its subsequent amendments to enable a market-oriented gas sector.²² The government will encourage more gas production through incentives such as pricing regimes and clear disclosure of concession agreements and application progress. The 2013 Model

¹⁸ Although not a structural benchmark, the NEPRA guidelines ([http://www.nepra.org.pk/Draft/Guidelines%20For%20Determination%20of%20Consumer-end%20Tariff\(Methodology%20&Process\).pdf](http://www.nepra.org.pk/Draft/Guidelines%20For%20Determination%20of%20Consumer-end%20Tariff(Methodology%20&Process).pdf)) have been included in the letter of intent of the government for the IMF's EFF, with a targeted promulgation date of April 2014.

¹⁹ The program will focus on enhancing an enabling environment and commercializing state-owned companies for privatization. A program loan for state-owned enterprise reform, which includes privatization, is being prepared.

²⁰ Commercializing the DISCOs will help achieve the government's privatization targets.

²¹ Environmental and social risk mitigation costs will be included in the calculations.

²² Government of Pakistan. Ministry of Petroleum and Natural Resources. 2012. *Petroleum Exploration and Production Policy 2012*. Islamabad.

Petroleum Concession Agreement was published on the website of the Ministry of Petroleum and Natural Resources. Petroleum exploration blocks for the 2013 bidding round were awarded and three pricing notifications were issued by the Oil and Gas Regulatory Authority under the 2012 Petroleum Policy.

17. To ensure accountability and promote higher efficiency, all GENCOs and DISCOs, as well as the National Transmission Despatch Company, will enter into performance contracts with the government. Key performance indicators will be disclosed to the public. For subprogram 1, three DISCOs have signed performance contracts. In line with the IMF–EFF structural benchmark for the institutionalization of the CPPA, subprogram 1 sets out the operational framework for the CPPA. The CPPA will act as a single buyer on behalf of the DISCOs, enforce contracts and transactions, and ensure invoicing and payment. This will increase credibility especially for debt repayment. The memorandum and articles of association was amended to establish CPPA as an agent to purchase electricity on behalf of the DISCOs. In preparation of new power purchase agreements between the CPPA and the GENCOs, the CPPA has, on behalf of the DISCOs, entered into a heads of agreements with GENCO Holding Company. The heads of agreements includes the key principles of the new power purchase agreements. The target is for trading between bulk suppliers and buyers to begin by latest 2018.

18. **Output 3: Achieving accountability and transparency.** Better access will foster demand for information and a culture of transparency. Subprogram 1 sets out a mechanism to increase public access to energy sector information. The government will implement web-based open access to merit order dispatch and daily payment information for the power generation companies to reinforce prioritization based on economic rationale. Subsidy information is now included in each customer's bill to raise awareness of the amount of subsidies that the government provides. The DISCOs also publish monthly billing and collection data on their websites, including arrears aggregated by customer category. To monitor power policy implementation and NEPRA's performance, the ECC has instructed the Ministry of Water and Power and the Ministry of Petroleum and Natural Resources to set up monitoring units that report quarterly to the ECC on implementation progress. The two ministries will also appoint independent and internationally respected experts to review the quarterly reports and make recommendations. The reports and recommendations will be made public on a timely basis.²³

19. **Subsequent subprograms.** Subprogram 1 sets out a clear framework and establishes a solid foundation for future reforms. Policy conditions for subsequent subprograms will ensure that the implementation of reform measures initiated under subprogram 1 continues. The program requires flexibility in all subsequent subprograms to reflect any changes in Pakistan's economy, political situation, or other circumstances.

20. Subprogram 2 has 10 indicative policy conditions that cover all three reform areas and are to be completed by January 2015. Subprogram 2 actions are expected to include the following: (i) Output 1: notification of guidelines for tariff determination, publication of information on payment arrears, and a mechanism to keep the level of payment arrears capped; (ii) Output 2: reclassification and provisioning by DISCOs of receivables from customers; issuance of regulations on minimum energy performance standards and appliance labeling; notification of rules for stepping up gas production; signing of performance contracts between Ministry of Water and Power and industry participants, signing of energy supply agreements between the CPPA and each DISCO, signing (by the CPPA on behalf the DISCOs) of power purchase

²³ The review and recommendations of the advisors will be a part of the report but will not be edited by the relevant authorities. The report will be disclosed to the public after the ECC meeting.

agreements with generation companies, and signing of an agreement between WAPDA and the CPPA on the administration of IPPs' power purchase agreements; and (iii) Output 3: implementation of web-based access to information on amounts due to and payments by industry participants, and publication of information by industry participants on achievement of selected performance standards and indicators.

21. Subprograms 3 to 5 are intended to continue to build on the reforms begun under subprograms 1 and 2, with indicative policy actions in each of the three reform areas to be carried out by January of 2016, 2017, and 2018. Indicative policy actions for subprograms 3–5 include the following: (i) Output 1: determination of multiyear tariffs; (ii) Output 2: implementation of revenue protection programs by DISCOs and notification of national energy standards; establishment of a steering committee on national energy conservation policy; implementation of a restructuring plan for mid- and downstream gas operations; and implementation of a long-term, least-cost generation and transmission expansion plan; and (iii) Output 3: publication of key indicators under the power sector performance contracts, and of a review of compliance by power sector companies with licensing provisions; and disclosure of operational audit reports.

D. Development Financing Needs

22. Subprogram 1 comprises a single-tranche loan of SDR257,443,000. Subprograms 2 and 3, with a loan of \$150 million equivalent each, and subprograms 4 and 5, with a loan of \$250 million equivalent each, are all subject to further discussions between ADB and the government, and to the availability of Asian Development Fund resources. Subsequent subprograms will be submitted for ADB Board consideration upon completion of the policy triggers. Financing from ordinary capital resources and from cofinanciers on a parallel cofinancing basis may be considered. The World Bank is expected to provide cofinancing for the first (\$600 million) and second subprograms.²⁴ The policy matrix (Appendix 4) lists actions to be taken prior to Board consideration for subprogram 1, and proposed policy actions for subsequent subprograms. The government has requested a loan in various currencies equivalent to SDR257,443,000 from ADB's Special Funds resources to help finance subprogram 1. The loan will have a 25-year term, including a grace period of 5 years, an interest rate of 2.0% per annum during the grace period and thereafter, and such other terms and conditions as are set forth in the draft loan agreement. The programmatic approach will support reforms outlined in the development policy letter (Appendix 3) and policy matrix. The amount is determined by the significance of the energy sector to the overall economy, the expected development impact of the policy package based on its strength, and Pakistan's development financing needs.

E. Implementation Arrangements

23. The ECC will oversee and is the final government authority on the reforms (para. 22). The Ministry of Finance will be the program's executing agency, supported by the program coordination unit (PCU). The PCU will have overall responsibility for coordinating program monitoring and reporting. The Ministry of Petroleum and Natural Resources and the Ministry of Water and Power will be the implementing agencies, supported by their monitoring units. Each monitoring unit will be responsible for program reporting and discussing implementing issues with the PCU. The monitoring units will submit quarterly reports to the ECC. The report will be

²⁴ The one development policy letter was issued for all cofinancing institutions. The policy matrix may differ because of the different duration of support and timing of prior actions for subprogram 1. The policy matrix was developed through joint missions by cofinancing institutions to ensure consistency in policy advice and to avoid partial implementation of reforms by dividing the prior conditions between the institutions.

provided to ADB.²⁵ Technical assistance to support the program will be provided by ADB, Japan International Cooperation Agency, United States Agency for International Development, the World Bank, and other donors through their ongoing and new initiatives. ADB is processing a technical assistance loan for state-owned enterprise reforms, which will provide support for the PCU and the monitoring units.²⁶ The proceeds of the program loan will be disbursed to Pakistan in accordance with the provisions of ADB's Simplification of Disbursement Procedures and Related Requirements for Program Loans.²⁷ The loan proceeds will be used to finance the cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. The implementation period for the program is from October 2013 to June 2018.

III. DUE DILIGENCE

A. Economic and Financial

24. The proposed policy reforms under the program will contribute to the national economy by (i) reducing the subsidies for the power sector, (ii) increasing investment, production, and employment as a result of more reliable electricity, and (iii) lowering production and distribution costs. The electricity supply has increased after the government injected liquidity in June and July 2013 to pay overdue bills from DISCOs through the CPPA to the power suppliers. However, new payment arrears have accumulated, totaling PRs200 billion as of the end of December 2013.²⁸ Removing administrative barriers, reducing costs, and introducing automatic adjustment mechanisms for government bills will help eliminate the need for subsidies. A least-cost based fuel mix and market-oriented commercial system will lower costs and ease the burden on customers. Payment arrears will also decline if collection improves, if DISCOs improve their performance and stem system losses, and if the government pays the remaining subsidies on time. Reliability of power supply will be restored, thereby providing energy that supports economic growth. Subprogram 1 will generate economic benefits by establishing a policy framework for medium- to long-term reforms. It will also effect immediate changes to administrative procedures to increase sector revenues and efficiency and lower operating costs.

B. Governance

25. In line with the Second Governance and Anticorruption Action Plan, a governance, institutional, and corruption risk assessment is being conducted as part of the preparation of the CPS for Pakistan in 2014. As indicated in the draft assessment, Pakistan's score for various governance indicators fell below the regional average in 2012. However, the country has made progress in improving accountability, increasing transparency, and raising efficiency. The government has embarked on several reforms to strengthen the institutional framework, including budget management, financial accounting, and reporting and expenditure controls. As part of the IMF–EFF, the government has changed the tax policy to increase transparency. The recent focus has been on capacity building and training at the federal and provincial levels. A fiduciary risk assessment found that overall fiduciary risk at the federal level remains medium to high despite the progress observed within individual public expenditure and financial

²⁵ The monitoring framework is included in the Technical Memorandum (accessible from the list of linked documents in Appendix 2).

²⁶ Analytical, technical, legal, regulatory, and communications support for the program's duration will be provided.

²⁷ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

²⁸ Payment arrears increased from PRs105 billion in 2008 to PRs461 billion in 2012 and then fell to PRs90 billion in July 2013. See Circular Debt Impact on Power Sector Investment (accessible from the list of linked documents in Appendix 2).

accountability assessment areas. Even with the installation of SAP enterprise resource planning software and the introduction of a chief finance and account officer in line ministries as internal auditor, internal control and audit remain weak, as does the legislative oversight over budget formulation and execution. Although the institutional setup for public procurement has been established, not enough efforts have been made to augment the capacity of and the budget allocations to these authorities. To support the government in public financial management reforms, ongoing initiatives financed by various donors should be coordinated and complementary. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government. The government is acting against corruption, which includes ongoing monitoring and reporting work by the public accounts committee of the Parliament. Approximately PRs138 billion was recovered between July 2008 and February 2013.

C. Poverty and Social

26. The reforms supported under the program will accelerate economic growth and help create jobs, which are keys to reducing poverty. Reliable power will benefit the poor and vulnerable consumers, including hospitals and schools, who are hard hit by inadequate power supply, load shedding, and poor power quality. Small industries will be able to operate for more hours per day and thereby increase productivity, which in turn will create more work opportunities for the poor. Increases in the Human Development Index are strongly correlated with access to commercial electricity supplies. The indirect benefits of reliable energy supply include reduced work time, and better health of household members by reducing fume-related indoor pollution and water- and food-borne diseases by refrigeration and boiling water and food.

D. Safeguards

27. The program has been assessed as category C for both involuntary resettlement and indigenous peoples, and category B for environment. In the event of any unanticipated adverse environmental or social impacts, ADB's Safeguard Policy Statement (2009) (SPS) will be applied in its entirety and the loan will be recategorized. An environmental assessment for the entire program found that the policy action requiring the government to prepare a least-cost generation and transmission plan may have future impacts on the environment if not appropriately managed.²⁹ The covenants in the loan agreement include carrying out a strategic environmental assessment and making sure that any identified long-term environmental impact is managed in accordance with ADB's SPS (2009). If other policy actions are added to subsequent tranches, safeguard due diligence will be done to confirm or change the categorization.

E. Risks and Mitigating Measures

28. Major risks and mitigating measures are summarized in Table 1.³⁰ The integrated benefits and impacts are expected to outweigh the costs.

Table 1: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Inhibited productivity and reduced efficiency in the power sector because of circular debt.	The Government of Pakistan is taking steps to reduce circular debt by increasing the consumer tariff, paying subsidy on time, and pay debt owed by the power sector that accrued due to delays in tariff

²⁹ Environmental Assessment of the Policy Matrix (accessible from the list of linked documents in Appendix 2).

³⁰ The major risks and mitigating measures are described in detail in the Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

	notification and subsidy payments.
An economic downturn prompts less investment, limits fiscal revenue growth and thereby risks breaching the ratio of public debt to gross domestic product. ^a	The government has developed a macroeconomic reform plan, agreed with the International Monetary Fund under the extended fund facility program, which will remove economic constraints and, along with other reforms (including the proposed program), is expected to strengthen the fiscal position.
Lack of coordination in policy formulation and implementation by government ministries and agencies.	The Economic Coordination Committee oversees the reforms and receives quarterly reports. The Ministry of Finance will act as the coordinator for the various government entities and for transparency measures.
Lack of accountability because of weak corporate governance among energy sector PSEs.	Government's commitment to further strengthen the regulator's capacity and to continue monitoring the performance of PSEs will increase accountability in the sector and improve overall governance.
Legislative process may be slow and face resistance by vested interests, and legislations may not be promulgated.	The program is based on government's own policy and reform initiative and is backed by a strong political will and commitment, supported by the donor community through technical assistance where needed.
Reforms stall because of reluctance of stakeholders.	Transparency measures and information and education campaigns will help the stakeholders understand how the reforms benefit them.

PSE = public sector enterprise.

^a The ratio's level is stipulated under the Fiscal Responsibility and Debt Limitation Act 2005.

Source: Asian Development Bank.

IV. ASSURANCES

29. The government has assured ADB that subprogram 1 implementation shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents. The government has agreed with ADB on certain covenants for subprogram 1, which are set forth in the loan agreement.

V. RECOMMENDATION

30. I am satisfied that the proposed programmatic approach and policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the programmatic approach for the Sustainable Energy Sector Reform Program, and
- (ii) the loan in various currencies equivalent to SDR257,443,000 to the Islamic Republic of Pakistan for subprogram 1 of the Sustainable Energy Sector Reform Program, from ADB's Special Funds resources, with an interest charge at the rate of 2.0% per annum during the grace period and thereafter; for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

2 April 2014

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and/or Indicators with Baselines	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
Impact Economic growth through sustainable energy sector	<p>Improved GDP from –2.0% (2013) to –0.5% contribution of the power shortage by June 2022</p> <p>Subsidy to the power sector is reduced from 1.8% of GDP in June 2013 to 0.4% by June 2016 and remains below 0.4% by 2022</p> <p>Shortage of electricity reduced from 33% in 2012 to 12% by June 2022</p>	<p>Planning Commission statistics</p> <p>Ministry of Finance data</p> <p>NEPRA state of industry report</p>	<p>Assumptions Continued implementation of policy reforms with greater emphasis on efficiency and transparency</p> <p>The current IMF–EFF program is fully implemented</p> <p>Risk Economic downturn prompts less investment and limits fiscal revenue growth</p>
Outcome Reliable, sustainable, and affordable energy system	<p>Private investment as a share of total investments in the power sector increased from 19% in 2012 to 23% by June 2018</p> <p>Average power distribution and transmission system losses reduced from 21.86% in 2013 to 17.86% by June 2017 for all DISCOs and NTDC</p> <p>Unaccounted for gas reduced from 11% in 2013 to 8% by June 2018</p>	<p>NEPRA state of industry report</p> <p>NEPRA state of industry report</p> <p>OGRA report</p>	<p>Assumptions Political stability and security maintained</p> <p>Continued investment in the energy sector</p> <p>Risk Lack of coordination in policy formulation and implementation between government ministries and agencies</p>
Outputs 1. Managing tariffs and subsidies (ii) Clear policies on tariffs and subsidies that are targeted at low-income customers (ii) Ensure policy implementation through NEPRA rules and guidelines (iii) Reduction of discretionary policy decisions	<p>DISCO tariff determination reduced from more than 7 months after submission of petition (2013) for all DISCOs to within 4 months by June 2017</p> <p>Guidelines for DISCO tariff determination covering methodologies, timetable, formula, and procedures for both annual and multi-year tariffs, procedure for earlier submission on investment costs by</p>	<p>NEPRA website</p> <p>NEPRA website</p>	<p>Assumption Ministries and agencies have developed the capacity to implement policy actions efficiently</p> <p>Risk Necessary legislation not promulgated</p>

Design Summary	Performance Targets and/or Indicators with Baselines	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
and of lag in tariff approval and implementation	DISCOs, and forward-looking automatic FPA notified by NEPRA by December 2014 and implemented		
<p>2. Improving sector performance and market access for private sector participation</p> <p>(i) Reducing losses and improving collection rate of DISCOs</p> <p>(ii) Improving demand-side efficiency and strengthening energy conservation</p> <p>(iii) Managing generation costs through least-cost planning, and ensuring that new power generation plants follows the plan</p> <p>(iv) Increasing gas supply and opening the gas market to direct contracting between producers and large-volume gas consumers</p> <p>(v) Commercializing and improving the performance of public sector power companies</p> <p>(vi) Institutionalizing the commercial operations of the CPPA</p>	<p>Improvement in collection rate of DISCOs from 86% in 2012 to 94% of total billing by 2017</p> <p>Aging of government receivables reduced from 410 days (provincial) and 180 days (federal) to 90 days by June 2015</p> <p>Energy efficiency labeling on the 20 most energy-intensive appliances by June 2018</p> <p>Payment arrears remain below PRs220 billion starting from 2015 (May 2013: PRs503 billion)</p> <p>Long-term, least-cost generation and transmission expansion plan issued, and bidding for additions to three new power generation plants based on LCP completed by January 2018</p> <p>At least 5% of new gas supply, contracted directly to large gas customers and producers by January 2018</p> <p>Performance targets set in the executed performance contracts met by all DISCOs by December 2017</p> <p>CPPA becomes fully operational as an independent agency by December 2014 and starts bulk customer trading by December 2017</p>	<p>NEPRA state of industry report</p> <p>Annual audited financial statements of the DISCOs</p> <p>Energy efficiency standards</p> <p>MOWP website</p> <p>Government official gazette</p> <p>Government official gazette</p> <p>NEPRA state of industry report</p> <p>Amended NTDC license</p>	

Design Summary	Performance Targets and/or Indicators with Baselines	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
3. Achieving accountability and transparency in the power sector	<p>All key operational and payment information of the power sector published on CPPA's and DISCOs' websites by January 2016</p> <p>Timely and continued issuance of quarterly report on the implementation status of the National Power Policy 2013 from September 2014, and by June 2015 the report includes review and recommendations by international experts</p>	<p>CPPA and DISCOs websites</p> <p>MOWP website</p>	
Activities with Milestones^a			Inputs
1. Managing tariffs and subsidies <p>1.1. ECC approves Tariff and Subsidy Policy Guidelines [31 March 2014]</p> <p>1.2. Policy actions to implement Tariff and Subsidy Policy Guidelines [Subprograms 2 to 5]</p> 2. Improving sector performance and market access for private sector participation <p>2.1. MOWP submits to CCI a mechanism to automatically deduct amount of overdue bills owed by provincial governments and agencies [31 March 2014]</p> <p>2.2. Federal government issues instructions to automatically adjust bills of federal entities exceeding 90 days [31 March 2014]</p> <p>2.3. CPPA's Articles of Association establish CPPA as an agency; and CPPA signs, on behalf of DISCOs. [31 March 2014]</p> <p>2.4. Address supply and demand mismatch through efficiency and increased cost effective production [Subprograms 2 to 5]</p> 3. Achieving accountability and transparency in the power sector <p>3.1. Public disclosure and provision for web access on operational information, including merit order and daily payment instruction to generators by NTDC [31 March 2014]</p> <p>3.2. Subsidy amount included in customer's bills by all DISCOs [31 March 2014]</p> <p>3.3. DISCOs publish on their website monthly billing and collection data aggregated by consumer category [31 March 2014]</p> <p>3.4. Policy action to foster accountability through creating demand for information [Subprograms 2 to 5]</p>			<p>Subprogram 1 ADB: \$400 million World Bank: \$600 million Government: \$3,600 million</p> <p>Subprogram 2 ADB: \$150 million World Bank: TBD Government: \$3,100 million</p> <p>Subprogram 3 ADB: \$150 million Government: \$2,700 million</p> <p>Subprogram 4 ADB: \$250 million Government: \$2,600 million</p> <p>Subprogram 5 ADB: \$250 million Government: \$2,800 million</p>

ADB = Asian Development Bank, CCI = Council of Common Interests, CPPA = Central Power Purchasing Agency, DISCO = distribution company, ECC = Economic Coordination Committee, EFF = extended fund facility, FPA = fuel price adjustment, GDP = gross domestic product, IMF = International Monetary Fund, LCP = least-cost generation plan, MOWP = Ministry of Water and Power, NEPRA = National Electric Power Regulatory Authority, NTDC = National Transmission and Despatch Company, OGRA = Oil and Gas Regulatory Authority, PRs = Pakistan rupees.

^a Policy matrix includes detailed policy actions for each subprogram (Appendix 4).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=47015-001-3>

1. Loan Agreement: Asian Development Fund (program)
2. Sector Assessment (Summary): Energy
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter¹
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Technical Memorandum
11. Energy Sector Assessment
12. Fiduciary Risk Assessment
13. Circular Debt Impact on Power Sector Investment
14. Environmental Assessment of the Policy Matrix

¹ The linked document is the press release dated 24 March 2014. According to the International Monetary Fund (IMF), responses to the multilateral development banks' requests for the IMF assessment of a country's macroeconomic conditions and policies will be conveyed whenever possible through the most recent press release, Chairman's statement produced in the context of Article IV surveillance, IMF-supported program, or staff monitoring program, or a previous assessment letter, if it remains valid. Barring any major changes in the country circumstances, the public information notice, Chairman's statement, or previous assessment letters, are expected to remain valid for a period of up to 6 months. An assessment letter would only be called for if either (i) the most recent assessment is more than 6 months old, or (ii) if IMF staff considers that there have been material changes in the country's circumstances that call for an updated assessment.

DEVELOPMENT POLICY LETTER

No. I(4)EFC/2014



Senator Mohammad Ishaq Dar
Minister for Finance, Revenue,
Economic Affairs, Statistics and
Privatization

ISLAMABAD
March 27, 2014

Dear Presidents Kim, Nakao, and Tanaka,

Since our elections in May 2013, our government has adopted a long term strategy to restore macro-economic stability and enhance economic growth, in furtherance of which we have taken various initiatives with respect to:

- Fiscal consolidation and stability;
- Rebuilding foreign exchange reserves; and
- Structural reforms.

The energy sector is central to this program, and therefore our efforts towards its reform will directly impact the overall economic growth of Pakistan. Through this letter we wish to apprise you about the salient features of the Government of Pakistan's energy sector reform program. Our focus has been the development of a credible and actionable program which can be supported over the medium term by the Asian Development Bank (ADB), the World Bank (WB) and the Government of Japan acting through the Japan International Cooperation Agency (JICA).

I. RECENT DEVELOPMENTS

In June 2013, Pakistan achieved its first democratic transition of power from an elected government. The concurrent smooth transitions at the highest levels of the military and judiciary provide further evidence that the democratic process has taken hold. This of itself will go a long way in support of the implementation of effective measures to address Pakistan's challenging economic situation characterized by a low growth rate, infrastructure bottlenecks, falling investment, gaps in fiscal requirements and weak macro-economic framework. The public debt-to-GDP ratio was 62.7% in FY2013, mainly owing to actual deficit being higher than projected.¹ We expect that the ratio will be 61.4% for FY 2014 and will take measures to maintain it below 60% from FY2015 onwards.

It is forecast that economic growth is likely to scale up in the current Fiscal Year 13/14. Inflation is expected to remain in single digit for the remainder of the year due to smooth supply of essential items and better price monitoring by the government.

Pakistan's energy sector, which is a pivotal contributor to the overall economic situation, is facing a severe crisis, especially with regard to electricity. Despite a 160 percent tariff increase in nominal terms since 2008, revenues are still falling short of costs, and the Government continued to subsidize electricity to a tune of up to about 2.75 percent of GDP in FY12/13. The fallout is cyclical, and has resulted in chronic electricity shortages, peaking at over 7,000MW in 2013 and averaging between 3,000-4,000MW. Weak governance, poor management and a lack of accountability at all levels not only contributed to the shortages but resulted in widespread non-payment of bills, further exacerbating the crisis, the most tangible manifestation of which is the circular debt which reached PKR 503 billion in mid-2013.

¹ Debt Policy Statement 2013-14, page 33.

The major contributors of this situation include:

- Insufficient supply of fuel brought about by acute liquidity shortages;
- Reliance on expensive imported heavy fuel oil and diesel for generation;
- Poor equipment maintenance;
- Poor efficiency of use by consumers;
- Poor pricing; and
- Widespread theft.

II. OUR POLICY RESPONSE

To address this situation, the Government of Pakistan, has been working closely with the State Bank of Pakistan and the international community to develop and implement a comprehensive policy response, aimed at achieving macroeconomic stabilization while also addressing fundamental fiscal, monetary, financial sector issues and structural impediments for unlocking Pakistan's growth prospects in the medium term. The details are contained in the following paragraphs.

A. Macroeconomic Stabilization

To immediately inject stability in the country's macroeconomic framework, the Government, as a priority area, immediately approved fiscal consolidation measures, such as reorienting the monetary policy to begin rebuilding foreign exchange reserves, launching a new tax enforcement program and other measures to reduce government budget deficits to sustainable levels.

In September 2013, in support of these measures, the Government of Pakistan and the International Monetary Fund (IMF) entered into a 36 month Extended Fund Facility (EFF) for an amount of about US\$6.68 billion. The IMF, after being satisfied with the performance of the Government during the first review of the EFF in November 2013, approved the disbursement of US\$553 million. Following the second review, IMF has disbursed US \$556 million in March. It may be noted that the IMF's EFF is part of a wider program, totaling a minimum of US\$12 billion needed to support Pakistan over the medium term.

Immediately upon taking office, we took steps to settle the power sector circular debt, and by July had reduced it by PKR 480 billion, thus adding an estimated 1,700MW of generation that had been lying idle for several months. We also increased tariffs for bulk, industrial and commercial consumers by an average of 44 percent in August 2013, and for household and agricultural consumers by an average of 32 percent in October 2013.

The Government has also approached international partners, including the ADB, JICA and the World Bank, for budgetary support to co-finance the wider reform program. The areas for policy reforms under discussions include new measures in tax administration, trade competitiveness, the business climate and access to finance as well as the energy sector.

B. The Government's Vision and Objectives for the Energy Sector

Being cognizant of the severe consequences of the energy sector on the economic condition of the people of Pakistan, and in furtherance of its commitment to overcoming these challenges, the Government announced National Power Policy, 2013, in July 2013, within three months of taking office.



The key goals and targets envisioned under the Policy include:

Goals	<ul style="list-style-type: none"> • To enhance generation capacity in a sustainable manner • Promote and ensure a culture of conservation and responsibility • Ensure affordable electricity, based (where possible) on indigenous fuels • Minimize losses (technical, financial) and inefficiency • Control pilferage and theft, and • Align the sector ministries provincial and federal authorities, regulators, and implementing entities, to coordinate activities, and strengthen governance
Targets – to be achieved by 2017	<ul style="list-style-type: none"> • Decrease/eliminate the demand/supply gap – from around 7000 MW at peak times currently, to zero • Decrease weighted average generation cost from about USc 12/kWh today, to below 10 USc per kWh • Reduce transmission and distribution losses from 23-25% today to about 16% • Increase collection rates from 85% (system wide) to above 95%, and • Reduce decision times for the Government, related departments, regulators, etc.

In September 2013, the Government prepared a detailed plan aimed at turning this vision into an actionable program. Subsequently, the program was discussed with stakeholders, including the private sector, academia and civil society, donor agencies, the utility providers, and bilateral governments, and their respective role in support of the program was identified, i.e.

- a) Supporting the implementation of the Government's policies;
- b) Public sector counterparts and utilities ensuring that they meet their obligations for various projects and programs; and
- c) Enabling the Government to monitor the progress in achieving the objectives and targets set out in the Government's policies, and take corrective actions where required.

The proposed policy actions, and for which we seek support from WB, JICA, and ADB, are discussed in more detail below.

C. Structural Reform of the Energy Sector

The reform program is aimed at improving the financial viability of the power sector and involves a three pronged strategy, i.e.

- To better manage tariffs and subsidies;
- Improving sector performance and opening the market to private participation; and
- Improving the transparency and accountability of sector institutions.

Managing Tariffs and Subsidies

The Government recognizes that a significant decline in investments and persistent failure to increase electricity prices has created a backlog in terms of cost recovery which has not been eliminated despite the 160 percent energy price increase between FY08/09 and October 2014.

To this end, we have agreed on a phased program of adjustments with the IMF aimed at raising tariffs to full cost recovery, while the Government will provide only targeted subsidies to the households that fall within the lowest 20 percent in terms of per capita income. It is expected that these measures will reduce the level of power sector deficit from 2% to no more than 0.4% of GDP by FY16/17. These savings will help in reducing the overall budget deficit and also

enable the Government to finance investments in low cost generation, rehabilitation of existing public sector generation plants, and implementing loss reduction programs at the distribution companies (DISCOs).

Comprehensive tariff and subsidy policy guidelines for the electricity sector have also been issued. These are aimed at reducing the discretion which is allowed under the existing process for tariff determination i.e. by moving to a formula based and multi-year tariff regime, while empowering the National Electric Power Regulatory Authority (NEPRA) to determine as well as notify tariffs. Provision has also been made for deemed notification of tariff, if not notified by the Government within the time stipulated by NEPRA. It will also streamline and expedite the process for the submission and determination of tariff petitions.

The policy guidelines also include arrangements for a tariff equalization mechanism to allow the elimination of the Tariff Differential Subsidy and a transition to multi-year tariffs for DISCOs and Karachi Electricity Supply Company (KESC). Based on this policy, NEPRA will be able to develop tariff rules and regulations consistent with the policy. By FY17, all DISCOs will be on a multi-year tariff with automatic, forward-looking fuel adjustment mechanism.

Last, through the policy guidelines, we have put in place a requirement to improve the management of tariff subsidies and the circular debt. Tariff subsidies are already budgeted, and from FY14/15 we will introduce a mechanism to ensure that subsidies do not exceed the budgetary allocation. We will also introduce in the coming fiscal year, better accounting to ensure that the sources and accountability for the circular debt are clearly identified, and we will institute a mechanism to cap and reduce the circular debt. We will manage the circular debt by resolving provincial dues, recovering private receivables and by making regular settlement if required.

Several of the requirements introduced in the policy guidelines have consequences for tariff setting. NEPRA has introduced complementary guidelines and is undertaking consultations. We expect the NEPRA guidelines to be in place in time for the FY 14/15 tariff setting round, expected to start in about April 2014.

Improving Sector Performance and Opening the Market to Private Participation

Six broad areas of action have been identified with respect to reforming and improving sector performance and facilitate private participation.

1. **Reduction of line losses and improving collections in distribution companies (DISCOs):** As a first step, we plan to outsource billing and collection for feeders where Aggregate Technical and Commercial (ATC) losses exceed 50% to the community schemes. We are also requiring all DISCOs to develop and implement revenue protection programs. We have further initiated actions to adjust receivables owed by provincial governments and agencies, and federal agencies or entities. Proposals to further increase the private sector's role including management contracts, outsourcing technical and operational functions, and outright privatization are being considered by the Government.

The Government is also endeavoring to create an environment which promotes the maximum utilization of existing assets, while discouraging and penalizing waste and inefficiency. In this regard, efforts are being made to improve supply side efficiency and strengthening energy conservation.

2. **Energy Efficiency:** Under the IMF program, we are committed to placing the Energy Efficiency and Conservation Bill before Parliament, which
 - Promotes international performance standards as the benchmark for all equipment and appliances to be produced and sold in Pakistan;



- Establishes a single point authority to prepare and implement a comprehensive energy efficiency and conservation program;
- Addresses jurisdictional issues;
- Empowers provinces to monitor the production and sale of equipment that complies with approved standards.

In parallel we also plan to issue enabling regulations on minimum energy performance standards, energy labelling requirements and energy efficiency standards all of which will be notified in accordance with the law.

3. **Least Cost Planning:** The lack of focus on selection of the least cost projects has also contributed toward the high cost of generation. Accordingly, the Government is re-introducing the requirement for least-cost planning in the National Transmission and Despatch Company (NTDC), to ensure that only those projects are considered for implementation which fit specified criteria, taking into account considerations of location, fuel choice, and economic cost of power to be produced over the lifetime of the project, as well as making explicit social, environmental and other associated safeguard costs.
4. **Re-invigorating Domestic Gas Production:** The 2012 Petroleum Exploration and Production Policy, which significantly enhanced the price of gas following commercial discovery, has been strongly welcomed by the industry. The Government's efforts to promote this policy to investors in 2012 also evoked favorable responses. Following the conclusion of the first bidding round in March 2013, we now have substantial acreage in about 50 exploration blocks which are ready for award to the respective bidders. We completed the award of these blocks in January 2014, Oil and Gas Regulatory Authority (OGRA) has announced the applicability of the 2012 Policy price and the gas price for the respective concessions for five new blocks/concessions by end-January 2014. It will announce the pricing for the remaining blocks within this year. To ensure that there are no delays in the award of these blocks, a Model Concession Agreement has been finalized by the Directorate General Petroleum Concessions and announced on the Ministry of Petroleum and Natural Resources' website. In the coming year we will review the structure of the mid and downstream gas sector, with a view to its restructuring in FY15/16.

We will ensure compliance with performance parameters of companies that have been awarded concessions for exploration as well as execution of Gas Transmission Agreements with the utilities, for willing buyers and sellers.

5. **Performance Driven Management by Public Sector Power Utilities:** The DISCOs are being instructed to implement the requirements of the Companies' Ordinance 1984. In this regard, three DISCOs have already signed performance contracts with the Government and a mechanism to monitor the utilities' performance under these Contracts is being finalized. By FY15/16, all DISCOs, Generation Companies (GENCOs) and NTDC will be monitored through such contracts. The Contracts will include provisions for Boards of Directors and managements to be rewarded when agreed performance targets are achieved or exceeded and penalized when they are not.
6. **Developing a Wholesale Power Market:** Over the past few years, the Government and the utilities have worked with ADB to establish a wholesale market for power. To this end, we intend to make the Central Power Purchasing Authority (CPPA) independent of all other power sector entities. We will introduce market rules to allow direct contracting between producers and large consumers of electricity at negotiated prices including



providing transparent pricing for wheeling electricity over the public network. In the first phase, the power purchase and sale functions will be devolved from NTDC to CPPA and NTDC's license will be modified so that it can no longer purchase or sell electricity. Institutionalization of CPPA is a prior action under the IMF program, and we have also completed the required formalities including amendment to and finalization of the Memorandum and Articles of Association, appointing a Chief Executive and other key staff.

Going forward, the process will further evolve in three phases:

- a) Initial functioning of CPPA as agent of DISCOs, for the purchase of power from public and private sector power producers. Accordingly we will ensure that DISCOs each sign agency agreements with CPPA. CPPA will also sign power purchase agreements (PPAs) with public generation companies, and take over administration of the independent power producers' contracts from NTDC;
- b) Provision of direct sales between generators and large customers under a Single Buyer Plus (SBM+) model; and
- c) Transition to a wholesale market, where large consumers can buy directly from generators, with NTDC and DISCOs performing only transmission and wheeling functions.

Improving Accountability and Transparency

The status of actions under the Power Policy and follow up actions under the Petroleum Exploration and Production Policy is being monitored regularly by the Economic Coordination Committee (ECC) of the Federal Cabinet. Review at the highest level demonstrates the importance which the Government attaches to implementing the energy sector reform plan.

Mechanisms are also being set up for periodic monitoring of the power and petroleum policies. We have established monitoring units in MWP and MPNR charged with monitoring of the progress of the reforms, reporting to the Economic Coordination Committee on a quarterly basis, and disseminating energy sector information to the public. We will also hire advisors to review the reports and to provide commentary, and we will make public their reviews. We will ensure reporting of the results through web-based forums which allow all stakeholders (including citizens) to review progress and contribute their views. The proposed culture of monitoring and transparency will also require enhanced regulatory capacity, for which, bilateral/multilateral assistance is also being sought. We will also establish a government-wide communications program, and will seek assistance from our partners to help in its establishment.

Further measures to promote transparency, some of which have already been initiated, will increase access to information in the energy sector through implementing web-based access to operational information on electricity generation, including the merit order dispatch, and payments made to generators, billing and collection etc.

In the longer term, we will implement public web-based information about the performance of DISCOs, GENCOs and NTDC against the benchmarks set in their contracts. NEPRA and OGRA will also be obliged to publish information monthly on the performance of Licensees. This will be overseen by the two monitoring units at MWP and MPNR.

III. GOVERNMENT COMMITMENT

We take this opportunity to reiterate our commitment to reforms and dealing with the policy issues. We have already taken some difficult decisions including substantial tariff increases and the settlement to the power sector circular debt which are already yielding positive results. The level of electricity generation on average during June 2013 to January 2014 has been 6.4 percent higher than the corresponding period in the previous year. We are committed to continue to make the necessary decisions to improve the power sector's financial viability.

You will appreciate that the measures described above to reform the energy sector constitute the strongest efforts yet undertaken for many years. Notwithstanding, we recognize that bringing the energy sector back on track requires continued efforts. The government's plan to deal with the structural impediments to the performance of the energy sector is matched by our commitment for improving the quantity and quality of physical investment in the sector, wherever possible with private sector investment participation.

In closing, we would like to express our continued appreciation of ADB, JICA and the World Bank for working with the government in the development of a single program for the energy sector that is closely integrated with that of the IMF. We look forward to continuing to work closely with your institutions in our common purpose of improving Pakistan's economic prospects.

Kind regards,

Sincerely,


Mr. Jim Yong Kim,
 President,
 The World Bank

Mr. Takehiko Nakao,
 President,
 Asian Development Bank

Mr. Akihiko Tanaka,
 President,
 Japan International Cooperation Agency (JICA)

POLICY MATRIX

Objective	Prior Actions Subprogram 1 To be completed by 31 March 2014	Indicative triggers to be supported through Operation 2	Indicative triggers to be supported through Operation 3	Indicative triggers to be supported through Operation 4	Indicative triggers to be supported through Operation 5	Results
Policy Area A: Managing Tariff and Subsidy						
Adoption of clear policies on tariffs and subsidies to target low income consumers; ensuring policy implementation through NEPRA rules and regulations; and reduction of discretionary policy decisions and lag in tariff approval and implementation.	<p>1. The Economic Coordination Committee (ECC) approved the Tariff and Subsidy Policy Guidelines covering:</p> <ul style="list-style-type: none"> (i) subsidy policy for low-income residential customers, (ii) multi-year tariffs, (iii) guidance for tariff setting as envisaged in the NEPRA Act, including forward-looking fuel price adjustment through NEPRA proceedings, and (iv) guidance for circular debt management (a) monthly accounting for arrears of payment by DISCO to CPPA, (b) mechanism to cap the overdue payables to the power generators. <p>2. NEPRA published on its website for consultation draft guidelines for DISCO tariff determination covering principles, methodologies, timetable, formula and procedures for both annual and multi-year tariff (MYT), including (a) procedure for DISCO to submit investment costs prior to filing of petition; and (b) adjustment mechanisms during the year including formula-based forward-looking automatic fuel price adjustment (FPA).</p>	<p>1. Further to consultation referred to in prior action 2 of subprogram 1, NEPRA [notifies] guidelines for DISCO tariff determination covering principles, methodologies, timetable, formula and procedures for both annual and multi-year tariff (MYT), and including (a) procedure for DISCO to submit investment costs prior to filing of petition; and (b) adjustment mechanisms during the year including formula based forward-looking automatic fuel price adjustment (FPA).</p> <p>2. Further to the Tariff and Policy Guidelines 2014 Government (i) publishes on the CPPA website monthly overdue payables to the power generators disaggregated to DISCO level; (ii) MOWP publishes cap for overdue payments not to exceed [PRs 220 billion];¹ and (iii) maintains overdue payments below the cap for at least [3] months.</p>	1. NEPRA issues determination on multi-year tariff for at least 2 DISCOs.	1. NEPRA issues determination on multiyear tariff for at least 4 additional DISCOs.	1. NEPRA issues determination on multi-year tariff for at least 4 additional DISCOs.	<p><i>Result Indicator A1: Time taken for DISCO tariff determination.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): more than 4 months after admission of petition for all DISCOs. • Target (FY16/17): within 4 months admission of petition for all DISCOs. <p><i>Result Indicator A2: Regulation for DISCO tariff determination covering methodologies, timetable, formula and procedures for both annual and multiyear tariff (MYT), procedure for earlier submission of investment costs by DISCOs, and forward-looking automatic FPA.</i></p> <ul style="list-style-type: none"> • Baseline (FY11/12): not notified. • Target: notified by NEPRA by April 2014. <p><i>Result Indicator A3: Subsidies reduced.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): 1.8% of GDP. • Target (FY16/17): 0.3%–0.4% of GDP.

¹ The cap is indicative and will be determined based on third party circular debt audit which is currently ongoing and mechanism which is being developed.

Objective	Prior Actions Subprogram 1 To be completed by 31 March 2014	Indicative triggers to be supported through Operation 2	Indicative triggers to be supported through Operation 3	Indicative triggers to be supported through Operation 4	Indicative triggers to be supported through Operation 5	Results
Policy Area B: Improving Sector Performance and Opening the Market to Private Participation						
Loss reduction and improving collections in DISCOs.	3. (i) MOWP instructed PESCO, HESCO, SEPCO, and MEPCO to outsource to the private sector collection of their respective feeders with losses of 50% or above ; (ii) MOWP instructed all DISCOs to implement revenue protection program that ensures correct billing, reduces losses, in particular theft, and improves collections; (iii) Council of Common Interests initiated discussion for mechanism to automatically adjust amount of receivables owed by provincial governments and agencies; and (iv) Federal Government adjusted receivables of federal agencies or entities not to exceed 90 days of billing by DISCOs.	3. Each DISCO identifies and assesses existing consumer receivables and their respective recoverability to reflect, in accordance with the Companies Ordinance and the General Accounting Practices, re-classification and provisioning of the qualified receivables in its audited financial statements for fiscal year ended 30 June 2014.	2. At least 3 DISCOs have developed and started implementation of their revenue protection programs.		2. All remaining DISCOs have developed and started implementation of their revenue protection programs.	<p><i>Result Indicator B1: Reduction in distribution and transmission losses.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): 21.86% for DISCOs and NTDC. • Target (FY16/17): 17.86% for DISCOs and NTDC. <p><i>Result Indicator B2: Increase collection in DISCOs.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): 86% of bills collected by DISCOs. • Target (FY16/17): 94% of bills collected by DISCOs. <p><i>Results Indicator B3: Reduction of government receivables.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): provincial 410 days, federal 180 days. • Target (FY13/14): 90 days.
Improving demand side efficiency and strengthening energy conservation.		3. MOWP issues regulation(s) on (i) minimum energy performance standards (MEPS) for at least 3 energy-intensive consuming appliances or technologies, and (ii) appliance labeling.	4. MOWP establishes a steering committee on national energy conservation policy coordination and implementation which includes ENERCON as secretariat.	2. MOWP notifies national energy efficiency standards in accordance with the approved Energy Conservation Act.		<p><i>Result Indicator B4: Notification of energy efficiency standards.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): no MOWP issued MEPS. • Target (FY16/17): at least five MEPS issued by MOWP.

POLICY MATRIX

Objective	Prior Actions Subprogram 1 To be completed by 31 March 2014	Indicative triggers to be supported through Operation 2	Indicative triggers to be supported through Operation 3	Indicative triggers to be supported through Operation 4	Indicative triggers to be supported through Operation 5	Results
Managing generation cost through Least Cost Planning (LCP), and ensuring new generation entry follows the LCP.	4. MOWP issued an instruction establishing the principles and process for NTDC to prepare the long-term least-cost generation and transmission expansion plan ² and its periodic update.		4. NTDC submits and NEPRA approves long-term least-cost generation and transmission expansion plan. 5. PPIB updates procedures and documentation of 2002 IPP policy to ensure consistency with least-cost plan for competitive and unsolicited bids from IPPs for new capacity.			<p><i>Results Indicator B5: Introduce LCP and entry of new generation based on LCP.</i></p> <ul style="list-style-type: none"> • Baseline: no approved LCP. • Target (FY16/17): LCP issued and additions to new generation capacity based on LCP. <p><i>Result Indicator B6: Increasing gas supply.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): 3.8 billion scfd. • Target (FY16/17): 5 billion scfd.
Increasing gas supply and opening the gas market to direct contracting sales to large gas consumers.	5. (i) MPNR disclosed the 2013 Model Petroleum Concession Agreement on their website; (ii) MPNR announced the award of petroleum exploration blocks for the 2013 bidding round; and (iii) OGRA issued at least 3 pricing notifications under the 2012 Petroleum Policy.	4. MPNR notifies rules for enhancing gas production from producing, dormant or under-producing concessions.	6. Government approves a restructuring plan for the mid- and down-stream gas sector. 7. MPNR reviews and notifies enhanced/revised 2012 Petroleum Policy to promote additional gas production from domestic on- and off-shore areas.	3. MPNR has started implementation of a restructuring plan for the mid- and down-stream gas sector.		

² The plan will be prepared in accordance with the government of Pakistan's standing commitments on national and international policies and conventions on climate change and environmental safeguards as well as include for the environmental and social costs.

Objective	Prior Actions Subprogram 1 To be completed by 31 March 2014	Indicative triggers to be supported through Operation 2	Indicative triggers to be supported through Operation 3	Indicative triggers to be supported through Operation 4	Indicative triggers to be supported through Operation 5	Results
Commercialization and improving performance of public companies in the power sector.	6. MOWP signed performance contract including operational and financial performance indicators and the monitoring framework with at least 3 DISCOs.	5. MOWP signs performance contract including operational and financial performance indicators and the monitoring framework with all GENCOs, NTDC and all remaining DISCOs.		4. MOWP signs enhanced performance contract with DISCOs, GENCOs and NTDC taking into account the results of the audit referred to in Indicative Trigger 11 of Operation 3.		<p><i>Result Indicator B7: DISCOs meet key targets in performance contracts.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): 3 DISCOs signed performance contracts. • Target (FY16/17): DISCOs meet set performance targets.
Commercial Operation of CPPA as independent agency to buy power on behalf of DISCOs, and implementation of a multiple buyers market by allowing generators to contract sales directly with large consumers.	7. (i) CPPA's memorandum and Articles of Association amended to establish CPPA as an agent to purchase electricity on behalf of distribution companies (including DISCOs); and (ii) CPPA signed on behalf of DISCOs with GENCO's Holding Company on behalf of GENCOs, Heads of Agreement (HoAs) reflecting key principles for power purchase agreements for existing thermal plants, with energy price based on heat rate testing; which HoAs have been endorsed by the respective Board of Directors.	<p>6. (i) NTDC files request and NEPRA amends NTDC license to remove CPPA functions and NTDC's authority to purchase or sale electricity; and (ii) CPPA signs an energy supply agreement with each DISCO to procure power on their behalf.</p> <p>7. (i) CPPA signs on behalf of DISCOs PPA with WAPDA Hydel and PPAs with all GENCOs, one PPA for each operational thermal plants of GENCOs; and (ii) WAPDA enters into agreement with CPPA for administration of PPAs of IPPs under 1994 policy.</p>	8. CPPA submits and NEPRA approves the market rules, allowing generators direct contract sales to bulk power consumers, and covering market registration, balancing operations, and settlement and billing among market participants.	5. CPPA implements approved market rules allowing direct contracting with bulk power consumers.		<p><i>Result Indicator B8: CPPA legally, institutionally and operationally independent from NTDC.</i></p> <ul style="list-style-type: none"> • Baseline (FY12/13): CPPA still a unit within NTDC. • Target (FY15/16/19): All contracted power generated by IPPs, GENCOs and WAPDA Hydel are traded through an independent CPPA.

POLICY MATRIX

Objective	Prior Actions Subprogram 1 To be completed by 31 March 2014	Indicative triggers to be supported through Operation 2	Indicative triggers to be supported through Operation 3	Indicative triggers to be supported through Operation 4	Indicative triggers to be supported through Operation 5	Results
Policy Area C: Accountability and Transparency						
Increasing access to information in the energy sector.	8. NTDC implemented web-based open access to operational information, including merit order, and daily payment instruction to generators. 9. Each DISCO (i) included subsidy amount in customer's bills; and (ii) published on its website monthly billing and collection data aggregated by consumer category.	8. CPPA implements web-based access to monthly amount due and payment by DISCOs to CPPA, and by CPPA to generators.	9. MOWP implements public web-based access to monthly information results of performance contract, provided by DISCOs, NTDC and GENCOs.			<p><i>Result Indicator C1: Access to operational and payment information publicly available from website.</i></p> <ul style="list-style-type: none"> Baseline (FY12/13): information not available on website. Target (FY16/17): information available on CPPA and DISCO websites. <p><i>Result Indicator C2: Access to licensees' performance available on NEPRA website.</i></p> <ul style="list-style-type: none"> Baseline (FY12/13): information available only in NEPRA annual State of Industry Report. Target (FY16/17): information available on NEPRA website and updated monthly.
Strengthening NEPRA.		9. NEPRA publishes at least monthly on its website, monthly information provided by all licensees on selected performance standards results and indicators.	10. NEPRA publishes review of WAPDA Hydel, GENCOs, DISCOs, KESC and NTDC compliance with license provisions.	6. NEPRA publishes review for at least 30 IPPs on compliance with license provisions.	3. NEPRA publishes review for all remaining IPPs on compliance with license provisions.	
Monitoring and Surveillance.	10. ECC approved establishment of monitoring units within both MOWP and MPNR with the responsibilities of monitoring the energy sector, reporting on quarterly basis and make public disclosure of the quarterly report; and MOWP and MPNR formulated the scope of work for advisors to review quarterly monitoring reports and provide advice and recommendations on the implementation of the reforms which will be made public.		11. MOWP discloses on its website annual operational audit reports provided in accordance with the signed performance contracts.			<p><i>Result Indicator C3: Quarterly reporting and public disclosure on the implementation status of the energy sector reforms.</i></p> <ul style="list-style-type: none"> Baseline (FY12/13): not available. Target (FY13/14): first report published by September 2014.