ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 48031-001
November 2014

Proposed Technical Assistance Loan Islamic Republic of Pakistan: Public Sector Enterprise Reforms Project

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 3 November 2014)

Currency unit	–	Pakistan rupee (PRs)
PRs1.00	=	$0.0097
$1.00	=	PRs102.8609

ABBREVIATIONS

ADB	–	Asian Development Bank
CFW	–	Corporate Finance Wing, Finance Division, Ministry of Finance
ECC	–	Economic Coordination Committee
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance, Revenue, Economic Affairs, Statistics and Privatization
MOWP	–	Ministry of Water and Power
MPNR	–	Ministry of Petroleum and Natural Resources
PMU	–	project management unit
PSE	–	public sector enterprise
SDR	–	special drawing right
SECP	–	Securities and Exchange Commission of Pakistan
SESRP	–	Sustainable Energy Sector Reform Program
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government of Pakistan and its agencies ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2014 ends on 30 June 2014.

(ii) In this report, “$” refers to US dollars

Vice-President	W. Zhang, Operations 1
Director General	K. Gerhaeusser, Central and West Asia Department
Director	B. Wilkinson, Public Management, Financial Sector, and Trade Division, CWRD
Team leaders	R. Barreto, Financial Sector Specialist, CWRD
	J. Farinha, Financial Sector Economist, CWRD
Team members	S. Ali, Senior Project Officer (Financial Sector), CWRD
	M. Hodge-Kopa, Economist (Public Finance), CWRD
	F. Kawawaki, Principal Energy Specialist, CWRD
	A. Mukhamedyarova, Financial Sector Specialist, CWRD
	J. Ngai, Counsel, Office of the General Counsel
	K. Rosbach, Economist, CWRD
	F. Teves, Project Analyst, CWRD
	M. Yabut, Operations Assistant, CWRD
Peer reviewer	H. Mukhopadhyay, Senior Public Management Economist, South Asia Department

CONTENTS

PROJECT AT A GLANCE

1. Basic Data

Project Number: 48031-001

Project Name	Public Sector Enterprise Reforms Project	**Department /Division**	CWRD/CWPF
Country	Pakistan	**Executing Agency**	Ministry of Finance
Borrower	Islamic Republic of Pakistan		

2. Sector

Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Economic affairs management	2.00
	Reforms of state owned enterprises	18.00
	Total	**20.00**

3. Strategic Agenda

Strategic Agenda	**Subcomponents**
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded

Climate Change Information

Climate Change impact on the Project	Low

4. Drivers of Change

Drivers of Change	**Components**
Governance and capacity development (GCD)	Institutional development Organizational development Public financial governance
Private sector development (PSD)	Conducive policy and institutional environment Public sector goods and services essential for private sector development

Gender Equity and Mainstreaming

No gender elements (NGE)	✓

5. Poverty Targeting

Project directly targets poverty	No

Location Impact

Nation-wide	High

6. Risk Categorization: Low

7. Safeguard Categorization

Environment: C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	**Amount ($ million)**
ADB	**20.00**
Sovereign Project loan: Asian Development Fund	20.00
Cofinancing	**0.00**
None	0.00
Counterpart	**2.54**
Government	2.54
Total	**22.54**

9. Effective Development Cooperation

Use of country procurement systems	Yes
Use of country public financial management systems	Yes

Source: Asian Development Bank

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed technical assistance (TA) loan to the Islamic Republic of Pakistan for the Public Sector Enterprise Reforms Project.[1]

2. The project will strengthen the Government of Pakistan's capacity to privatize and restructure its designated public sector enterprises (PSEs) by (i) strengthening the privatization program; (ii) improving corporate governance, structure, and management capacity in selected PSEs; and (iii) enhancing governance and regulatory regimes in selected sectors currently dominated by PSEs.

II. THE PROJECT

A. Rationale

3. PSEs constitute a large share of Pakistan's economy, contributing about 10% of gross domestic product (GDP).[2] The federal government of Pakistan has equity in more than 200 commercial and semicommercial organizations. Years of weak sector and corporate governance, corporate mismanagement, unnecessary staff recruitment, and interference by line ministries in operational affairs have contributed to PSEs' poor service delivery and crippling financial problems.[3] Over the past few decades, the government has not had sufficient capabilities—institutional, technical, and legal—to instill sustained improvements in PSE management. Political objectives have often conflicted with commercial realities, undermining PSE performance and limiting commercial prospects.[4]

4. Taxpayers ultimately bear the costs of these inefficiencies. Many PSEs have been imposing significant fiscal costs, requiring discretionary fiscal transfers and sovereign credit guarantees to continue operating. Without strict performance conditions and credible sunset clauses, the government has inadvertently enabled a corporate culture of soft budget constraints that removes incentives for PSEs to improve. The fiscal transfers to PSEs are estimated at several hundred billion Pakistan rupees per year.[5] In addition to these transfers, PSEs had accumulated domestic debt of PRs366.5 billion and external debt of PRs205.7 billion equivalent by the end of December 2013.[6]

5. Most PSEs suffer from low labor productivity and poor management. For key PSEs in infrastructure services, such as power distribution, tariff collection is deficient and revenues are

[1] The design and monitoring framework is in Appendix 1.
[2] J. Speakman. 2012. SOE Reform: Time for Serious Corporate Governance. *World Bank Policy Paper Series on Pakistan.* PK04/12. Washington, DC: World Bank.
[3] Noteworthy for their recent poor performance are major PSEs including Pakistan International Airlines, Pakistan Railways, and Pakistan Steel Mills, along with regional power distribution companies and thermal power generation companies, which were under the control of the Pakistan Electric Power Company.
[4] J. Speakman. 2012. SOE Reform: Time for Serious Corporate Governance. *World Bank Policy Paper Series on Pakistan.* PK04/12. Washington, DC: World Bank; S. Aftab and S. Shaikh. 2013. Reforming State-owned Enterprises. *Pakistan Policy Note*. No. 4. Washington, DC: World Bank.
[5] The government has not been able to systematically track the PSE-related fiscal losses. They can be hidden through subsidies to end users, sovereign credit guarantees, asset depreciation, and other noncash measures. Fiscal transfers to PSEs were PRs512 billion in FY2012, of which PRs464 billion were for PSEs in the energy sector. World Bank. 2013. *Reforming State-owned Enterprises*, Pakistan Policy Note 4. Washington DC.
[6] State Bank of Pakistan. 2014. *Monetary Policy Information Compendium*. Karachi.

below cost-recovery levels.[7] Investments are thus insufficient to ensure competitiveness, and overall private sector growth is hampered by distorted product and infrastructure services markets. PSE service delivery is substandard. The government's footprint in the energy sector has produced inefficiencies that impose fiscal costs and create a circular debt problem.[8] This results from inefficiencies in state-owned power sector companies, such as workforces that exceed requirements and an inability to collect revenues. The direct involvement of the government in energy production and distribution has also reduced its ability to perform its regulatory role. Economically disadvantaged groups are not able to substitute inefficient public services with private sector alternatives. The sector needs to be revamped to sustainably remove this binding constraint on Pakistan's growth.

6. The Finance Division of the Ministry of Finance, Revenue, Economic Affairs, Statistics and Privatization (MOF) is the ultimate shareholder in PSEs where the government has equity participation or full ownership.[9] Within the Finance Division, the Corporate Finance Wing (CFW) is responsible for all financial and corporate matters related to PSEs, but its role has been limited to representation on the boards of PSEs and administration of PSE subsidies and guarantees. Line ministries are influential in PSE operations through (i) sector policies, (ii) appointment of the board (through the Prime Minister) and of the chief executing officer (before the Securities Exchange Commission of Pakistan [SECP] rules were issued), (iii) representation on PSE boards, and (iv) other indirect channels (managerial capture). The approval of subsidy requests for PSEs involves the board of directors and the respective line ministry, but the CFW processes the request for the finance minister's approval. This provides the CFW with opportunities to exercise different levels of stringency. However, the CFW has limited technical capacity and information to properly analyze and scrutinize the justification for requests, and thus to implement its legal mandate. The CFW recently started an assessment of the financial performance of PSEs. The first report is expected to be published by December 2014.

7. Successive governments in Pakistan have expressed concerns over the poor performance of PSEs and vowed to revamp these entities. However, repeated efforts to improve their performance have been unsuccessful. A rising number of stakeholders now favor government divestiture of most PSEs through a comprehensive reform program. Encouraging commitments have been made since September 2013 under a new International Monetary Fund (IMF) $6.7 billion extended facility:[10] the government has identified 68 PSEs for privatization, of which 31 PSEs are expected to be partially privatized.[11] For profitable PSEs, divestiture is expected through capital market transactions. For the more problematic PSEs, partial ownership and management control is likely to be transferred to strategic private investors.[12] However, key

[7] For example, despite a 160% increase in power tariffs since 2008, fiscal subsidies to power distribution companies remain high at 1.8% of GDP, or $3.8 billion equivalent.

[8] Circular debt is the amount of payments held back by an entity from creditors, so that it can push its cash flow problems down to other segments of the supply chain. In the Pakistan power sector, circular debt is the cash flow shortfall incurred by the sector with the Central Power Purchasing Agency at its center.

[9] Some PSEs are departmental or divisional undertakings that fall directly under the line ministry or even constitute a department, as in the case of Pakistan Railways. These undertakings are similar to PSEs, but since they are not distinguishable entities, they are here not considered as PSEs. They are part of the national budget and cannot accumulate debt independently, but can be costly to the budget.

[10] International Monetary Fund. 2014. *IMF Country Report No. 14/90*. IMF: Washington DC.

[11] Government of Pakistan, Privatisation Commission. Broad-Based Privatisation Programme of the Government. http://www.privatisation.gov.pk/Policy%20and%20Objectives/Privatisation%20Programme.htm

[12] Actions on these 31 PSEs are listed as IMF program conditions. Eleven of them—in the oil and gas, banking, insurance, and power sectors—have been identified for privatization by block sales in the capital markets. In 17 companies—mainly in the energy sector—increased private sector participation is expected to improve the value of the government's residual shareholding. Three PSEs in the oil and gas sectors are marked for restructuring, followed by privatization in segments.

constraints to these PSE reforms need to be addressed to lower fiscal pressures from PSEs and to improve service provision and sector management.

8. The results of privatization and restructuring programs have been mixed, both internationally and in Pakistan. Past privatization efforts in Pakistan's finance sector have been more successful than those in the main infrastructure sectors. Without a strategically planned and paced restructuring and privatization program, it is difficult to ensure consistency and transparency, and vested interests and lawsuits can stifle reforms.[13] Recent political commitments are yet to be framed into a comprehensive and time-bound strategy for restructuring, privatization, and governance improvements in the PSEs and in the sectors dominated by PSEs. An effective communications plan is also crucial to inform the public about the PSE reform program and its benefits and costs. This can generate widespread public support for the changes, and prevent political economy issues from derailing reform implementation. Technical capacity at key agencies and coordination mechanisms between them need to be strengthened.

9. TA and expert advice will also be crucial for the strategic restructuring work that many PSEs require before any further divestiture can take place. However, almost a decade of reduced privatization activity has drained the technical capacity of the Privatisation Commission, which has seen most of its senior transaction managers and legal counsels depart. Much of the senior-level institutional memory of the challenges that past privatization drives faced and how those were overcome has been lost.[14] The Privatisation Commission Fund does not have the resources needed to manage and pay for the significant pre-transaction work at key PSEs.[15] The current rules and practices on the use of these resources, which mix funding for privatization transaction advisers with funding for the commission's general operational expenditures, can be improved. These shortfalls prevent the fund from becoming a transparent and effective tool to support privatization. The current regulatory regimes in the infrastructure sectors also lack appropriate institutions and rules for effective regulation if the PSEs are privatized.

10. Funding will also be required to meet the substantial adjustment costs needed to implement PSE restructuring and privatization. The costs include voluntary separation schemes for workers, debt legacy retirement, and potential write-off of uncollectible receivables by the power distribution companies (total receivables of more than PRs480 billion as of 30 June 2013). As privatization proceeds will not accrue immediately, these revenues may not be able to finance a substantial part of the adjustment costs. The government has asked the Asian Development Bank (ADB) and other development partners to support the strategic policy and

[13] An impact assessment of the last Pakistan privatization program concluded that it was a success. Of the 95 PSEs privatized from 1991 to 1996, 32% performed better after privatization, 39% performed at the same level, and 29% performed worse. Privatization proceeds (totaling 4.3% of GDP) had some macroeconomic significance. Key recommendations to the government included (i) develop a comprehensive public awareness program, and (ii) gain access to a constant source of advice on utility sector reform and regulatory matters. ADB. 1998. *Impact Analysis of the Privatization in Pakistan*. Consultant Report. Unpublished (TA 2905-PAK). An ADB independent evaluation concluded that developing member countries' privatization experience was positive, but privatization had proceeded largely without attention to the sequencing of reforms and appropriateness of the approach for maximizing its effectiveness. Independent Evaluation Department. 2001. *Special Evaluation Study on the privatization of public sector enterprises: Lessons for developing member countries*. Manila: ADB.

[14] The government established the Privatisation Commission in 1991 to implement the privatization program. In 2000, the Privatisation Commission was converted into a sovereign corporate body.

[15] All privatization proceeds are deposited in a distinct and separate account called the Privatisation Fund. The fund is currently resourced with about $10 million equivalent. It is a revolving fund that is replenished with proceeds from the privatization of PSEs. The retention levels have not yet been set with the Finance Division of the MOF.

financial requirements of the PSE reform and privatization agenda.

11. The project will finance TA for PSE reforms, primarily in the form of consulting services. This assistance is aligned with the interim country partnership strategy for Pakistan and is included in the country operations business plan, 2014–2016.[16] The country operations business plan also includes two programmatic assistance loans (budget support) to help address the adjustment costs of PSE reforms (para. 10), one of which—the Sustainable Energy Sector Reform Program (SESRP)—has already been approved.[17] The project will contribute to the implementation of these two programmatic assistance loans by providing the government with technical inputs and capacity to monitor the reforms. The ADB processing team is coordinating its proposed intervention with other development partners active in this area, particularly the Department for International Development of the United Kingdom, the IMF, the United States Agency for International Development, and the World Bank.

B. Impact and Outcome

12. The impact will be reduced fiscal and economic costs associated with Pakistan PSEs. The outcome will be successful privatization and restructuring of selected PSEs.

C. Outputs

13. The project's outputs will help the government address the technical and policy requirements of its PSE reform agenda, enabling it to (i) define a strategy that coordinates different government agencies, sets guiding principles (such as transparency and consistency on labor-related issues), and incorporates sequencing concerns (including important trade-offs between fiscal space and the timing of transactions); (ii) communicate effectively from the onset; and (iii) initiate and implement the key preparation work for PSE restructuring (pre-transaction technical advice) to help minimize the necessary adjustment costs during and after privatizations, and maximize any residual shareholding value after partial divestment.

14. **Output 1: Strengthened privatization program** (footnote 11). The Privatisation Commission will be the implementing agency for this output, which includes two sub-outputs:

(i) **Output 1.1: Transactions management.** The project will finance consulting services to strengthen the technical capacity of the Privatisation Commission to manage privatization transactions and monitor transactions advisory services. The recruitment of experienced transaction managers for the commission will enable it to handle more complex and more frequent transactions in parallel (and to manage transactions advisors effectively). This action will also help the commission to develop a better perception of the potential market value of the

[16] ADB. 2014. *Islamic Republic of Pakistan: Interim Country Partnership Strategy, 2014-2015*. Manila; ADB. 2014. *Country Operations Business Plan: Pakistan, 2014–2016*. Manila.

[17] ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan to the Islamic Republic of Pakistan for Subprogram 1 of the Sustainable Energy Sector Reform Program*. Manila. Many of the government's generation and distribution power companies are PSEs that have significant fiscal and economic impacts. The SESRP focuses on the technical, commercial, and regulatory issues in the energy sector, which complements and supports outputs 1–3 of this project, where the Ministry of Water and Power (MOWP) and the Ministry of Petroleum and Natural Resources are implementing agencies. Project preparatory technical assistance for $500,000 is being processed to prepare the other policy-based programmatic assistance loan ($400 million) to offer strategic support to the PSE reform agenda. This second programmatic assistance loan will help the government address the adjustment costs of the reform agenda (para. 10) and complement budget support to be provided by the IMF and other development partners.

assets for sale and the available transaction technology options. This will strengthen the credibility of and public confidence in the privatization program. Expert legal assistance will also be provided to assist the commission in all relevant legal aspects of the transactions.

(ii) **Output 1.2: Privatization program effectiveness and transparency**. The project will enhance the current approach to privatization, and make it more strategic, well-sequenced, and time-bound with clear guidelines for prioritizing the different steps required for PSE privatization. This sub-output also includes preparation and implementation of an effective, sustained, and preemptive communications strategy to improve transparency and ensure that the need for the reforms and planned activities are widely understood and accepted by the public. A mitigation framework for labor-related issues arising from the privatization program—a key step to gain public acceptance—will also be developed and implemented under this sub-output.

15. **Output 2: Improved corporate governance, structure, and management capacity in selected public sector enterprises.** The Privatisation Commission, the Finance Division of the MOF (the Economic Reforms Unit and the CFW), and the SECP will be the implementing agencies for this output, which includes two sub-outputs:

(i) **Output 2.1: Public sector enterprise restructuring**. TA and expert advice will be crucial for the strategic restructuring work that many PSEs require before any further divestiture can take place. The business advisory, pre-transaction work that is necessary to prepare corporate restructuring proposals for key PSEs (e.g., balance-sheet bifurcation proposals,[18] improvement of internal financial controls and financial reporting, and reorientation of markets and operations) will be undertaken under this sub-output. This work may involve the services of management consultants, accounting and legal experts, and financial restructuring experts. The government will propose the PSEs to be restructured under the project, which should meet the following criteria: (a) the PSE is imposing significant direct and indirect costs to the federal government budget; (b) the government has in place a long-term vision for the sector where the PSE operates; and (c) the government clearly demonstrates its will to lead, guide, and complete the restructuring process within the project implementation period.

(ii) **Output 2.2: Public sector enterprise performance monitoring**. The project will fund accounting, management, and financial consulting services to develop the capacity of the CFW and the Economic Reforms Unit to monitor the PSE portfolio, assess fiscal liabilities, identify and track potential PSE issues, and oversee corporate restructuring of selected PSEs. The project will also help develop the analytical capacity of the CFW and the Economic Reforms Unit to carry out sector benchmarking and compare performance of PSEs. The project will support SECP enforcement of PSE compliance with the new corporate governance rules and guidelines by establishing interagency coordination mechanisms and an online reporting and monitoring system at the SECP.[19]

16. **Output 3: Enhanced governance and regulatory regimes of selected sectors currently dominated by public sector enterprises.** For effective privatization of PSEs in

---

[18] Corporate restructuring solutions may include separation of assets and liabilities of PSEs into several legal entities.

[19] SECP. 2013. *Public Sector Companies (Corporate Governance) Rules, 2013*. http://www.secp.gov.pk/CG/SRO_180_PublicSectorCompanies_CGRules_2013.pdf

some key sectors, it is essential to ensure that appropriate legal, sector regulation, and enforcement mechanisms are in place and are consistently implemented. To ensure that efficiency gains in PSEs providing infrastructure services do not come at the expense of the consumer, effective regulatory regimes also need to be established, particularly for ongoing medium-term reforms in the energy sector (footnote 17). The Economic Reforms Unit and specific regulatory agencies will oversee the work under this output, which has two sub-outputs:

(i) **Output 3.1: Energy sector reform monitoring**. Monitoring units for the SESRP will be established in the Ministry of Water and Power (MOWP) and in the Ministry of Petroleum and Natural Resources (MPNR). These units will support the ministries in preparing quarterly reform monitoring reports to be submitted to the Economic Coordination Committee (ECC). TA in the regulatory, technical, legal, and communications areas will be provided through the project to assist with the implementation of the SESRP. Technical experts will also be hired to monitor reform progress. Support through analytic studies will also be considered in coordination with other development partners.

(ii) **Output 3.2: Key sector reforms**. Assistance to other regulatory authorities can be selectively provided under this sub-output, particularly in sectors related to Output 2.1. The project will finance the recruitment of technical experts to support sector efficiency assessments and the preparation of sector restructuring road maps, which will be prepared in coordination with the respective line ministries and the Ministry of Planning, Development and Reform. The project will also finance the recruitment of experts to conduct competition assessments in sectors affected by the privatization and restructuring of PSEs, and where market concentration is high. These assessments will be prepared in coordination with the Competition Commission.

17. **Output 4: Efficiently and effectively managed project**. Consultants will be recruited to support the project management unit (PMU) that will implement and manage all activities funded by the project. The consultants will provide expertise in project management, financial management, and procurement.

D. Investment and Financing Plans

18. The project is estimated to cost $22.54 million (Table 1) , of which $16.86 million (74.8%) is for consulting services.

Table 1: Project Investment Plan
($ million)

Item	Amount[a]
A. Base Cost[b]	
Strengthened privatization program	4.85
Improved corporate governance, structure and management capacity in selected public sector enterprises	7.84
Enhanced governance and regulatory regimes of selected sectors currently dominated by public sector enterprises	5.82
Project management	1.20
Subtotal (A)	**19.71**
B. Contingencies[c]	**1.58**
C. Financing Charges During Implementation[d]	**1.25**
Total (A+B)	**22.54**

[a] Includes taxes and duties of $1.04 million to be financed from government resources.

[b] In mid-2014 prices.
[c] Physical contingencies computed at 5% for consulting services and studies. Price contingencies are computed using Asian Development Bank cost escalation factors; includes provision for potential exchange rate fluctuation under the assumption of a purchasing power parity exchange rate.
[d] Includes interest charges computed at a 2% fixed rate per annum.
Source: Asian Development Bank.

19. The government has requested a loan in various currencies equivalent to 13,459,000 special drawing rights (SDR) from ADB's Special Funds resources to help finance the project. 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 set forth in the draft loan and project agreements. The government will finance the costs of all local taxes and duties, office equipment (computers, printers, and scanner) and stationery for the PMU, training materials, translation services, bank charges, and financing charges during implementation. The government contribution is estimated at $2.54 million. The financing plan is in Table 2.

Table 2: Financing Plan

Source	**Amount** ($ million)	**Share of Total** (%)
A. Asian Development Bank		
Asian Development Fund (loan)	20.00	88.7
B. Government	2.54	11.3
Total	**22.54**	**100.0**

Source: Asian Development Bank.

E. Implementation Arrangements

20. The project will be implemented from April 2015 through 31 December 2019. The Finance Division of the MOF will be the executing agency. A PMU, which will be established in the Finance Division, will be responsible for overall coordination and reporting on implementation progress. The Finance Division of the MOF and the Privatisation Commission will be responsible for the procurement and recruitment of consultants. The ECC will oversee the implementation of the project.[20] The MPNR, MOWP, the Privatisation Commission, and the SECP will be the implementing agencies. ADB missions will review the implementation of the project at least twice a year.

21. The MPNR and MOWP will establish units to monitor the progress of reforms in the energy sector. The units will produce quarterly reports to submit to the ECC and ADB. Each monitoring unit will discuss implementation issues with the PMU. The reports will be reviewed by a team of advisors recruited under the project; the advisors will give suggestions and recommendations as part of the report.

22. The implementation arrangements are summarized in Table 3 and described in detail in the project administration manual.[21]

[20] The ECC is the highest economic policy-making body, formed by the Cabinet to make decisions on economic issues and transactions involving government interests, as well as to review key economic indicators. The ECC, which normally meets once a week, comprises all the key ministers heading economic ministries.
[21] Project Administration Manual (accessible from the list of linked documents in Appendix 2).

Table 3: Implementation Arrangements

Aspects	Arrangements		
Implementation period	April 2015–December 2019		
Estimated completion date	31 December 2019		
Management			
(i) Oversight body	Economic Coordination Committee		
(ii) Executing agency	Finance Division, MOF		
(iii) Key implementing agencies	Ministry of Petroleum and Natural Resources Ministry of Water and Power Privatisation Commission Securities Exchange Commission of Pakistan		
(iv) Implementation unit	PMU at the Finance Division, MOF (3 staff) Monitoring units at the Ministry of Water and Power Ministry of Petroleum and Natural Resources		
Procurement	National competitive bidding	2 contracts	$0.5 million
	Shopping	4 contracts	$0.4 million
Consulting services	QCBS	901 person-months	$14.6 million
	ICS	398 person-months	$3.3 million
Retroactive financing and advance contracting[a]	For (i) remuneration for PMU project manager, PMU procurement specialist, PMU project accountant, and two transaction managers (individual consultants) for the Privatisation Commission; and (ii) advance payments for the energy sector reforms firm, corporate restructuring and privatization firm(s), and for the communications firm.		
Disbursement	The loan proceeds will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2012, as amended from time to time) and detailed arrangements agreed upon between the government and ADB.		

ADB = Asian Development Bank; ICS = individual consultant selection; MOF = Ministry of Finance; PMU = project management unit; QCBS = quality- and cost-based selection.

[a] The borrower has been advised that ADB's approval of advance contracting will not commit ADB to subsequently approve the project or to finance the recruitment costs; and ADB will not finance expenditures paid by the borrower before loan effectiveness, even if advance contracting is approved, unless retroactive financing has also been approved by ADB. The government requested ADB to conduct, on behalf of the government, the selection processes up until but not including negotiations for the project manager, procurement specialist, and project accountant for the PMU; and the energy sector reform firm.

III. DUE DILIGENCE

23. The beneficiaries will primarily be the domestic, industrial, agricultural, and commercial clients of public goods and services provided by PSEs, which will deliver improved services. Taxpayers and recipients of government services will indirectly benefit from the reduced fiscal costs of PSEs. Workers in PSEs are expected to benefit from a consistent and fair approach to labor retrenchment, which will be provided through the mitigation framework for labor-related matters to be developed under the project.

A. Economic and Financial

24. The PSE reform agenda supported by the project is economically viable since the efficiency gains are expected to exceed the adjustment costs. The conclusions are supported by the financial analysis. Successful privatization that reduces the fiscal drain of PSEs will benefit taxpayers and the beneficiaries of public goods. The availability of higher-quality goods and services provided by privatized companies are expected to compensate for tariff adjustments.[22]

[22] Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2).

B. Governance

25. The financial management assessment showed that the Finance Division of the MOF and the Privatisation Commission have higher-quality internal control systems than most of the systems in the government. However, these agencies do not fully meet international standards of governance. The Finance Division of the MOF has experienced control breaches, and many documents are maintained only on paper. The Privatisation Commission does not have a financial and accounting manual for implementation of the accounting procedure rules. These rules do not have a strong link with the Commission's internal control system. The Finance Division of the MOF and the Privatisation Commission have a limited number of staff with the required financial management skills. However, with the proposed mitigating measures in place (para. 31), the financial management arrangements are adequate to implement the project.

26. The Finance Division of the MOF lacks procurement specialists who have experience with ADB's Procurement Guidelines (2013, as amended from time to time) and the Guidelines on the Use of Consultants (2013, as amended from time to time). The Privatisation Commission possesses adequate skills, experience, and capacity to procure consulting services in accordance with ADB's Guidelines on the Use of Consultants. Basic concepts of procurement and practices being followed in the Privatisation Commission are largely consistent with ADB guidelines.[23]

27. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government, including the Finance Division of the MOF. The specific policy requirements and supplementary measures are described in the project administration manual.

C. Poverty and Social

28. The project will help the government reduce the economic and fiscal costs that Pakistan's PSEs are imposing on consumers, taxpayers, and beneficiaries of social services. The project will maximize the benefits that private management and improved corporate and sector governance can bring to PSE economic efficiency and financial feasibility. These changes are expected to improve access to basic services such as electricity. The PSEs to be restructured and privatized may decrease their demand for low-skilled labor. The project will develop a framework for labor issues, under which the government is expected to regularly consult labor unions to ensure that workers' rights are respected during restructuring and privatization. The poor are not expected to be affected by potential increases in tariffs to cost-recovery levels (e.g., electricity tariffs) if, as planned, existing government subsidies are retargeted at low-income households. The customer surveys to be financed by the project will monitor service delivery and tariff structures of PSEs throughout project implementation, with specific consideration of poor consumers. The government, with ADB support, is strengthening its national social protection program, which already includes a targeting framework.

D. Safeguards

29. The project will have no impact on the environment or on indigenous peoples, and does not entail any involuntary resettlement. It is classified as category C for environment, involuntary resettlement, and indigenous peoples.

---

[23] An assessment of the procurement capacity of the Finance Division of the MOF and of the Privatisation Commission is available upon request.

E. Risks and Mitigating Measures

30. The major risks and mitigating measures are described in detail in the risk assessment and risk management plan.[24] Deterioration of the political and security situation in Pakistan may affect investor confidence, and vested interests and legal obstacles may disrupt the reform agenda. The government's PSE reform and privatization program may focus only on profitable PSEs, reducing potential efficiency gains. To mitigate these concerns, the project will develop (i) a public communications plan to ensure transparency, raise public awareness and support for the reforms, and manage expectations about the accessibility and services provided by PSEs; and (ii) a mitigation framework for labor issues. The ECC will oversee project implementation. By helping the government lead the policy dialogue, the project will reduce the scope for vested interests to disrupt the reform agenda. Policy-based lending (programmatic assistance) is being prepared (footnote 17) to provide incentives to restructure fiscally costly PSEs.

31. To ensure compliance with ADB policies and guidelines, assistance and oversight will be required at the project level to address the small number of staff and weak financial skills, internal controls, cash management, and forecasting systems in the MOF's Finance Division and the Privatisation Commission. The PMU will engage full-time, qualified accountant and procurement specialists. ADB will provide the Finance Division with updated disbursement projections during review missions to help plan cash requirements. The project financial statements will be audited by the Office of the Auditor General of Pakistan. The project's integrated benefits and impacts are expected to outweigh the costs.

IV. ASSURANCES

32. The government and the Privatisation Commission have assured ADB that implementation of the project 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 project administration manual and loan documents.

33. The government and the Finance Division of the MOF have agreed with ADB on certain covenants for the project, which are set forth in the loan agreement and project agreement.

V. RECOMMENDATION

34. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan in various currencies equivalent to SDR13,459,000 to the Islamic Republic of Pakistan for the Public Sector Enterprise Reforms Project, 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 and project agreements presented to the Board.

Takehiko Nakao
President

11 November 2014

[24] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
Impact Reduced fiscal and economic costs associated with Pakistan's PSEs	Equity injections in loss-making PSEs reduced from an average of 0.07% of GDP in FY2012–FY2014 to an average of 0.01% of GDP in FY2020–FY2024	Finance Division of the MOF, annual federal budget reports	**Assumption** Government does not invest in new fiscally costly PSEs **Risk** PSE reform and privatization program may focus only on the profitable and less challenging PSEs
Outcome Successful privatization and restructuring of selected PSEs	Government divested from at least 4 fiscally costly PSEs[a] by 2019 Effective restructuring of at least 3 fiscally costly PSEs by 2019 Rules for all privatization transactions during 2015–2019 made publicly available at least 2 months before each tender announcement is published	Privatisation Commission financial statements; legal documents of PSEs Privatisation Commission Annual Report Privatisation Commission website	**Assumptions** IMF program remains on track Government commits to finance transaction advisory services **Risks** Vested interests and legal obstacles may disrupt the reform agenda The political and security situation may worsen and affect investor confidence
Outputs 1. Strengthened privatization program	At least 10 privatization transactions completed by 2019 Public education and communications strategy implemented during 2015–2019 Mitigation framework for labor-related issues prepared by December 2015 and implemented from 2016 to 2019	Cabinet order(s) Privatisation Commission rules or regulations and consultants' reports Privatisation Commission rules or regulations	**Assumption** Good coordination between Privatisation Commission, Finance Division of the MOF, and line ministries
2. Corporate governance, structure, and management capacity improved in selected PSEs	At least 75% of PSEs fully report to the SECP through the online system by 2019 (baseline: none in June 2014)	SECP corporate governance monitoring report	**Assumptions** Shareholders of PSEs are willing to work with PSEs to improve their corporate governance practices

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
	Due diligence reports completed for PSEs representing at least 50% of PSE assets (at book value) by 2019 (baseline: no due diligence reports in 2014)	Consultant's reports	Cooperation and coordination between the implementing agencies
3. Governance and regulatory regimes enhanced in selected sectors currently dominated by PSEs	Blueprints for revised market structures with efficient and transparent separation of regulatory and operational roles finalized for 2 sectors (by 2017) Reform monitoring reports by the MOWP and the MPNR submitted on a quarterly basis to the ECC (by 2019) Competition assessments conducted for at least 3 sectors affected by privatization and restructuring of PSEs (by 2019)	Project management unit reports ECC internal documents Privatisation Commission's website	**Assumption** Structural separation of PSEs and establishment of regulatory bodies is well sequenced
4. Project efficiently and effectively managed	At least 75% of activities completed on time	Quarterly reports submitted by PMU	**Assumption** PMU head and procurement specialists are appointed in 2014

Activities with Milestones	Inputs
1. Strengthened privatization program 1.1 Develop a privatization strategy for 2015–2019, including institutional strengthening of the Privatisation Commission (by June 2015), and support its implementation during 2015–2019 1.2 Prepare and support approval of the mitigation framework for labor-related issues, including initiatives to improve skills or business development options for staff that may be subject to redeployment or layoff (by December 2015), and support its implementation (2016–2019) 1.3 Design and support approval of the communications plan for the privatization program (by September 2015) and support its implementation (2015–2019) 1.4 Support management of privatization transactions (2015–2019) 1.5 Design and conduct consumer surveys annually (2015–2019) 1.6 Support improvement of the Privatisation Commission's internal financial rules and accounting software system (by December 2015) **2. Improved corporate governance, structure, and management capacity in selected PSEs** 2.1 Improve SECP monitoring systems of PSEs' compliance with corporate governance guidelines, including development of an online reporting system (by December 2015)	**Technical Assistance Loan** **ADB (ADF):** $20 million **Government:** $2.54 million

2.2 Improve MOF Finance Division's monitoring systems of the government's shareholding position in PSEs (2015–2019) 2.3 Support PSEs in establishing and improving good practices in corporate governance, internal financial controls, and financial reporting (2016–2019) 2.4 Complete selection of PSEs to be restructured under the project (by December 2015) 2.5 Support restructuring of specific PSEs (2016–2019) 2.6 Design and conduct consumer surveys annually (2015–2019) **3. Governance and regulatory regimes enhanced in sectors dominated by PSEs** 3.1 Support the MOWP and the MPNR in preparing quarterly reform monitoring reports to be submitted to the ECC (2015–2019) 3.2 Prepare blueprints for revised market structures for 2 selected sectors currently dominated by PSEs (2015–2017) 3.3 Consult with government, industry, and other stakeholders of the sector on the draft blueprints (2016–2017) 3.4 Facilitate government approval of the sector blueprint(s) (2016–2018) 3.5 Support independent competition assessments on sectors affected by privatization and restructuring of PSEs (2015–2019) **4. Project efficiently and effectively managed** 4.1 Recruit consultants and procure goods in line with the project administration manual (2015–2019) 4.2 Submit quarterly reports to ADB (2015–2019) 4.3 Prepare government completion report (June–December 2019)	

ADB = Asian Development Bank, ADF = Asian Development Fund, ECC = Economic Coordination Committee, GDP = gross domestic product, IMF = International Monetary Fund, MOF = Ministry of Finance, MOWP = Ministry of Water and Power, MPNR = Ministry of Petroleum and Natural Resources, PMU = project management unit, PSE = public sector enterprise, SECP = Securities and Exchange Commission of Pakistan.

[a] For the purpose of the project, fiscally costly PSEs are those that impose direct and indirect fiscal costs on the federal budget of at least 0.05% of GDP per year.

Source: ADB.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=48031-001-3

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Public Sector Management
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Economic and Financial Analysis
8. Country Economic Indicators
9. Summary Poverty Reduction and Social Strategy
10. Risk Assessment and Risk Management Plan