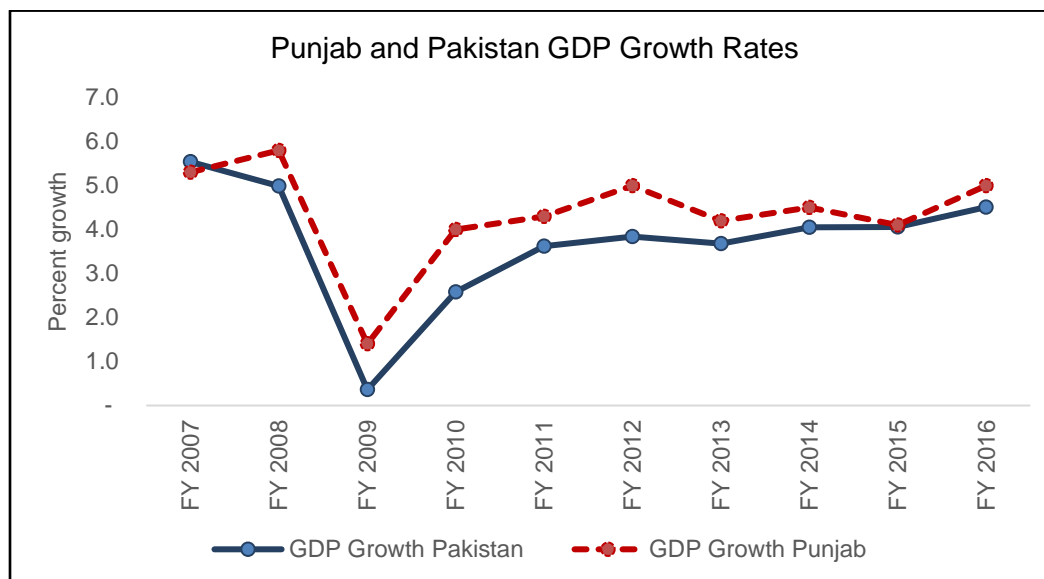


## SECTOR ASSESSMENT (SUMMARY): FINANCE

### 1. Sector Performance, Problems, and Opportunities

1. Punjab has a population of 110 million, which equals 53% of Pakistan’s population; Punjab’s population density (536 persons per square kilometer) is double that of Pakistan.<sup>1</sup> Punjab contributes 60% of the national gross domestic product (GDP),<sup>2</sup> underscoring its pivotal role in Pakistan’s economic growth and employment. Punjab’s provincial GDP grew at an annual average of 4.40% during FY2006 to FY2016, exceeding the national average of 3.75% over the same period.



FY = fiscal year; GDP = Gross Domestic Product

Source: Pakistan Economic Survey 2016-17, Finance Division; and Punjab Government estimates.

2. The role of agriculture in Punjab’s economy has declined substantially—its share of provincial GDP fell by approximately 16% during FY2006–FY2016, while the services sector increased by about 12% in the same period. However, agriculture remains essential to Punjab’s social fabric, and directly employed an estimated 40% of Punjab’s work force in 2014.<sup>3</sup>

3. Punjab is undergoing significant urbanization—the compounded annual urban population growth rate of 3.5% during 2007–2015 was four times the rural population growth rate, and the urban population reached 43 million in FY2015. The significant rural–urban migration is triggering challenges for cities that are unable to meet the demand for enhanced public infrastructure, housing and services to accommodate this transition. As the economy gradually shifts from labor intensive and subsistence farming and low value addition to services that have higher potential for growth and employment, the Government of Punjab (GOPb) must invest in improving connectivity and mobility, increasing access to and the quality of public utilities, and improving public health services to meet the needs of its population.

4. Economic growth in Pakistan has been hampered by a longstanding lack of investment in critical and quality public infrastructure. Public investment on infrastructure has declined over the

<sup>1</sup> Based on Population Welfare Department, Government of Punjab. Data: Population Profile Punjab.

<sup>2</sup> Punjab Board of Investment and Trade. [Punjab at a Glance](#).

<sup>3</sup> Punjab Bureau of Statistics, 2015. *Punjab Development Statistics 2015*. Lahore.

last decade—government investment in infrastructure in 2015 was \$5.7 billion, or 2.1% of GDP,<sup>4</sup> well below the estimated annual investment requirement of 7.6% of GDP (equal to about \$20.6 billion in 2015).<sup>5</sup> This has resulted in inefficiencies across the key infrastructure sectors, such as delays in transport of goods and limited access to energy and potable water, which affect public welfare and the country's overall industrial and economic growth.

5. To meet these challenges the GOPb increased its annual development program (ADP) by 15%, to an estimated PRs635 billion (\$6.0 billion) for FY2018,<sup>6</sup> from PRs550 billion (\$5.2 billion) for FY2017.<sup>7</sup> Infrastructure development absorbs 36% of the ADP, and is expected to increase by 13% to PRs230 billion (\$2.2 billion) in FY2018.<sup>8</sup> Social services account for 23% of the ADP, with an increase of 16% to PRs144 billion (\$1.4 billion) in FY2018. However, the available budget for public infrastructure investment is largely insufficient to meet the growing demand. Punjab's infrastructure investment requirement is estimated at \$3.6 billion to \$5.0 billion, significantly exceeding current public capital spending on infrastructure. To address budget constraints on infrastructure provision, the GOPb introduced the Punjab Public–Private Partnership for Infrastructure Act 2010 and the Punjab Public Private Partnership Act 2014 to augment private sector participation in infrastructure through public–private partnerships (PPPs).<sup>9</sup>

6. If properly structured and executed, PPPs can be an effective tool to advance construction and enhance operational efficiency of infrastructure projects through private partner expertise and incentives. However, PPPs carry significant fiscal risks that need to be managed and mitigated. To address these risks, legal and institutional reforms are required to identify, structure, and select only those PPPs that can maximize value-for-money (VFM) for the public.

## 2. Commercial Project Financing

7. Commercial banks in Pakistan are liquid, with deposits of PRs11.8 trillion (\$112 billion) in 2016. However, banks traditionally focus on funding attractive, low-risk federal government debt via government securities and loans. As a result bank credit to the private sector, though growing, remains very low at PRs410 billion, representing only 3.5% of deposits in 2016.

8. The role of commercial banks role in funding commercially viable infrastructure projects has increased significantly, with project finance exposures for tenors of up to 14 years increasing at a compounded annual growth rate of 10% during December 2010–December 2016, and reaching PRs471 billion.<sup>10</sup> A majority (63%) of commercial bank project finance supported power generation (which has well-established legal and regulatory frameworks that include standard power purchase agreements), followed by telecommunications (9%), petroleum (4%), and toll roads, bridges and flyovers (8%).

9. The limited offering of project financing is largely related to the continued preference by commercial banks for asset-backed corporate financing versus cash-flow-based project financing, and their reluctance to cover construction risks (including land acquisition and issues related to

<sup>4</sup> Based on World Bank. Data: [Gross Domestic Product](#) estimate for Pakistan of \$271 billion for 2015.

<sup>5</sup> Based on the estimated infrastructure investment needs for the South Asia region, which includes Pakistan. ADB 2017. *Meeting Asia's Infrastructure Needs*. Manila.

<sup>6</sup> Based on the currency exchange rate of 1\$=105.36 PRs, as of 17 August 2017.

<sup>7</sup> Government of Punjab. 2017. *Development Programme 2016–2017*. Lahore.

<sup>8</sup> Allocation for water supply and sanitation, which is classified under social sector, has been included in this estimate.

<sup>9</sup> [Punjab Public Private Partnership Act 2014](#).

<sup>10</sup> State Bank of Pakistan. 2017. [Infrastructure Finance Review: Jul–Dec, 2016](#).

acquiring relevant government approvals) that affect income generation (and thus debt servicing) by projects.

### 3. Public–Private Partnerships in Punjab

10. In accordance with the Punjab Public Private Partnership Act 2014, the GOPb established a PPP Cell (PPPC) in the Planning and Development Department, as well as guidelines to facilitate the structuring, and approval of PPPs.<sup>11</sup> The PPPC is intended to coordinate government line department efforts, and facilitate submission of PPP projects for approval by the PPP steering committee.<sup>12</sup> A dedicated Risk Management Unit (RMU) within the Finance Department reviews project proposals to determine potential fiscal risks and contingent liabilities related to PPP proposals prior to submission to the steering committee. Following steering committee approval, the relevant line department tenders the project to qualified private concessionaires and subsequently negotiates concession agreements and manages the PPP project over the term of the concession agreement.

11. The PPPC and RMU each review PPP project proposals from line departments covering technical, operational, and legal issues; compliance with the PPP guidelines; and risk management (fiscal and contingent liabilities). The PPPC has a staff of 40,<sup>13</sup> with limited PPP experience, while the RMU has one dedicated staff member with limited legal and project finance experience. Some steering committee members have limited project finance and PPP experience and rely on PPPC and RMU recommendations. The GOPb's limited PPP experience and resources may result in less-than-optimal structuring of PPP projects, and approval of PPPs that offer limited VFM. These projects may potentially expose the GOPb to unwanted contingent liabilities, and operational and fiscal risks in the long term.

12. The GOPb has received 40 PPP project applications from line ministries that are currently at various stages of preparation; 6 PPP projects have been awarded since 2010,<sup>14</sup> and 2 became operational as of April 2017. Under the current PPP regime the projects receive upfront government support through a viability gap fund (VGF) in addition to guarantees that provide comfort to the concessionaires if project revenue falls below certain thresholds. For example, a 25-year concession was awarded in 2016 for the Lahore Ring Road Southern Loop toll road project costing PR 25 billion (\$240 million). The agreement entailed (i) upfront capital VGF support of PRs4.25 billion (\$41 million) to pay for land acquisition,<sup>15</sup> (ii) free provision of land to the concessionaire, and (iii) a guarantee of 50% of the toll revenue shortfall to the concessionaire should the toll revenue fall below 80% of the estimated revenue.

13. The Lahore Ring Road comes at a high cost to the government and taxpayers, with significant commercial risks (traffic and private investment return risk) unnecessarily covered by the government, thereby delivering a project that offers limited VFM. VGF resources should be used to leverage PPP by (i) providing upfront capital relief to ensure commercial viability, and (ii) lowering the cost of capital by providing concessional funding or capital subsidies that do not require future budget payments. PPP projects should provide a reasonable balance between the private investor's interests and risks, and fiscal prudence.

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<sup>11</sup> Government of Punjab. Planning and Development Department. [Guidelines](#).

<sup>12</sup> Approving authority under the Punjab Public Private Partnership Act 2014.

<sup>13</sup> With teams covering transactions advice, projects, policy, communications and project monitoring.

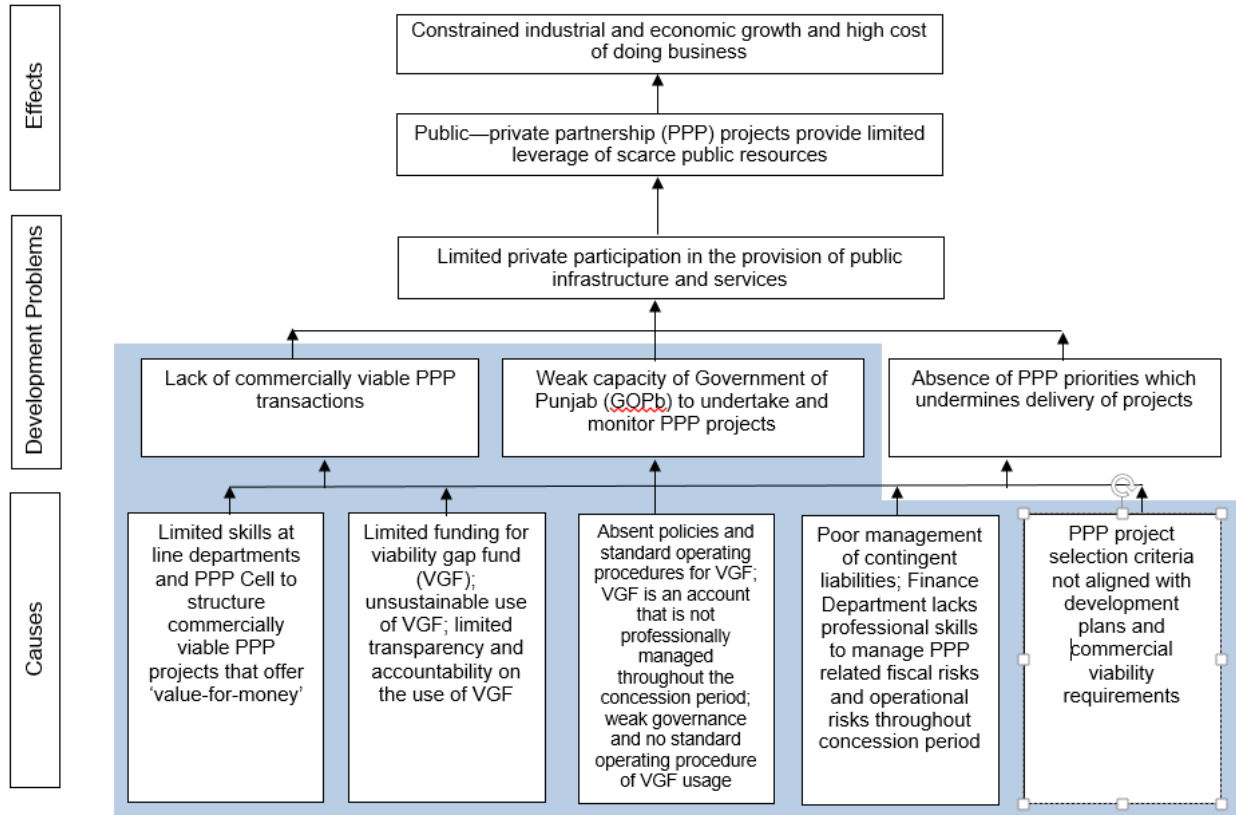
<sup>14</sup> Projects include roads, affordable housing and upgrade of health care facilities. Government of Punjab. Planning and Development Department. [Awarded Projects](#).

<sup>15</sup> Land acquisition cost is not capitalized and consequently not recognized as an equity contribution from the GOPb.

#### **4. ADB Project to Enhance Public–Private Partnerships in Punjab**

14. ADB's intervention under the proposed project will: (i) increase the number of staff and relevant PPP skills in the GOPb; (ii) facilitate the leveraging of scarce government resources to attract private sector financing; (iii) introduce a robust system to better manage and implement environmental and social safeguards in PPP projects; and (iv) enhance the capacities of relevant government agencies in the preparation, structuring, review and implementation of PPP project that offer VFM.

### Problem Tree: Public–Private Partnerships in Punjab



Note: The Enhancing Public–Private Partnerships in Punjab Project will aim to address the causes identified in the shaded areas.

Source: Asian Development Bank