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APPRAISAL STAGE

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Operation Name	Power Sector Reform: Second Development Policy Credit
Region	SOUTH ASIA
Country	Pakistan
Sector	General energy sector (100%)
Operation ID	P152021
Lending Instrument	Development Policy Lending
Borrower(s)	ISLAMIC REPUBLIC OF PAKISTAN
Implementing Agency	Ministry of Finance Q Block Pak Secretariat Islamabad Pakistan Tel: (92-51) 921-1168 nazrat.bashir@gmail.com
Date PID Prepared	March 29, 2015
Estimated Date of Appraisal	April 15, 2015
Estimated Date of Board Approval	June 19, 2015
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

1. This proposed second credit in a programmatic series of two single tranche operations continues IDA’s support for Pakistan’s goal of developing an efficient and consumer oriented electric power system that meets the needs of its people and economy sustainably and affordably. The proposed operation supports the government’s efforts to undertake much-needed structural reforms to the electric power sector that will improve its financial, technical and commercial performance. IDA financing would provide US$500 million equivalent. The proposed operation is part of a wide program of reforms aimed at lifting Pakistan’s growth potential.

2. Real GDP growth is forecast to be about 4.3 percent in fiscal year 2013-2014 (FY14/15), despite continued natural disasters and a difficult political and security situation. It is expected to increase further next year. The threat of a balance of payments crisis, severe a year ago, has receded. Foreign exchange reserves are projected to rise to over 3 months of imports by end FY14/15. The fiscal deficit is on target to be below 5 percent of GDP in FY14/15. Inflation is currently at about 5 percent, helped by lower energy prices. The IMF program is on track, having completed the sixth review in March 2015. Nevertheless, the economy is still vulnerable to shortages of energy, particularly electricity, natural disasters such as the floods experienced in 2014, and to lower than expected inflows of remittances, foreign direct investment (FDI) and taxes.

3. Poverty and human develoment remain a concern. The share of the population below the national poverty line fell from 34.7 percent in FY01/02 to an estimated 13.6 percent in FY10/11. More recent statistics have not been issued and many live at or near the poverty line. Growth appears to be pro-poor as real per capita consumption growth of the bottom 40 percent of the population – a measure of shared prosperity –exceeded that of the top 60 percent in the same period. The national Gini coefficient fell from 0.34 to 0.29 between FY98/99 and FY10/11. Social safety nets such as the Benazir Income Support Program (BISP) have redistributed wealth to the poor and vulnerable and have become especially important as growth has become more volatile. Despite these gains, Pakistan's human development indicators continue to be low. In 2013 public spending on health was 1% and education was 2.1%, of GDP, among the lowest levels worldwide.

4. Energy sector performance has improved but challenges remain. Subsidies to the sector were reduced in FY13/14 to about 1.2 percent of GDP, down from 1.5 percent the previous year. Falling oil prices have reduced input costs for electricity generation enabling tariffs to be adjusted downwards. A gap of about PKR 2/kWh remains, however, and the sector continues to suffer acute liquidity shortages. As a result, accumulated arrears of payment by the public electricity distribution companies (Discos) to their suppliers, commonly known as the circular debt, has started to re-emerge and currently stands at an estimated PKR 245 billion, or one percent of FY13/14 GDP. Targeting of subsidies towards the poorest remains an issue, as does the need to ensure that the sector develops in a socially and environmentally sustainable way.

II. Operation Objectives

5. Pakistan's goal is to develop an efficient and consumer oriented electric power system that meets the needs of its people and economy sustainably and affordably. The three guiding principles of the 2013 National Power Policy are efficiency, competition and sustainability, and it focuses on five main targets set out in Table 1 below.

Table 1: The Five Main Targets of the National Power Policy (July 2013)

Target	Current Situation	Goal and date
Decrease gap between supply and demand	4,500 – 5,000 MW shortfall	Reduce to zero by 2017
Improve affordability by decreasing cost of generation	Average generation cost 12 US¢/kWh	Reduce average generation cost to 10 US¢/kWh by 2017
Decrease aggregate technical and commercial transmission and distribution (T&D) losses	T&D losses currently about 23-25 percent	Reduce T&D losses to about 16 percent by 2017
Improve collection of billed electricity	Collections are currently about 85 percent of billing	Increase collections to 95 percent of billing
Improve governance by decreasing decision making times at Ministries, related departments and regulators	Slow decision making	Shorter processing times (goal yet to be established)

6. The government has developed an Action Plan to implement the National Power Policy over the next 3 to 5 years. The action plan ties together the policies and actions required to implement the specific strategies of the 2013 National Power Policy. The strategies are closely interlinked.

Achieving financial sustainability requires improving cash flows through tariffs reflective of efficient costs, promoting efficiency and performance of the companies through commercialization, and reducing losses, in particular theft. The government also considers that privatization of the Discos will help improve performance. Reductions in the cost of generation will come from increasing hydropower and gas in the generation mix and better efficiency, promoted through least cost planning. Subsidies must increasingly be targeted only to low-income households. Creating awareness and consensus for the policy implementation requires increasing transparency through greater access to information, strengthening the capacity of NEPRA and improving its accountability.

7. This is the second in a proposed series of two development policy credits (DPCs) supporting Pakistan's goal of developing an efficient and consumer oriented electric power system that meets the needs of its people and economy sustainably and affordably. The DPC focuses particularly on policy and institutional actions that will improve financial viability and thus reduce the burden of public financing for the sector.

8. Description of Prior Actions:

- Following the mechanism in 2014 Tariff and Subsidy Policy Guidelines, MWP has informed NEPRA of the FY14/15 subsidies by consumer category to incorporate in the tariff determination of each Disco, to apply in FY14/15 expected to result in electricity subsidies to be reduced to 0.7% of GDP.
- MWP has published in its website a cap for total overdue payables to power generators not to exceed PKR250 billion and a plan to reduce the flow of new overdue payables to [zero] by 2019 with interim targets of [__] in 2016, [__] in 2017 and [__] in 2018[1].
- The Government has implemented a mechanism based on tariff surcharges and Universal Obligation Fund to maintain national uniform tariffs in Discos while ensuring cost recovery.
- MPNR has signed supplemental agreements agreeing revised prices for [120] exploration concessions at the levels set out in the 2012 Petroleum Policy, including at least [20] from the private sector.
- Cabinet Committee On Energy has approved a policy directive that LNG will be provided to consumers who pay its full cost through the tariff.
- (i) CPPA (G) has demonstrated operational capability to handle all steps in the billing and settlement cycle of electricity sales by Generators and purchases by Discos; .and (ii) NEPRA has granted an amendment to NTDC license to eliminate CPPA functions.
- CPPA (G) publicly disclosed on its website the monthly amounts due, and payments made, by each Disco to CPPA (G), and by CPPA (G) to Generators, including arrears.
- NEPRA has disclosed the annual Discos performance and evaluation report, and has initiated outreach action to consumers on the content thereof; and Discos have disclosed on their respective websites their annual performance reports, including their plans to improve service delivery.

[1] Figures in brackets are yet to be proposed and will be subject to a due diligence review of the final plan

12. The following results indicators are selected for the project:

(i) Reduced subsidies allocated in the federal budget from a baseline of 1.8 percent of GDP in FY12/13 to 0.7 percent by the end of FY14/15;
(ii) Increased bill collection in Discos from a baseline of 86 percent of bills collected in FY12/13 to 94 percent of bills collected in FY15/16;
(iii) Increased domestic gas supply from 3.8 billion standard cubic feet per day in FY12/13 to 5 billion standard cubic feet per day in FY 15/16;
(iv) Separation of market operation and transmission system operation, with contracted power generated by IPPs, Gencos and WAPDA Hydel traded through an independent Central Power Purchasing Agency acting on behalf of Discos by the end of FY 15/16;
(v) Disco performance reports and NEPRA review published by FY14/15.

III. Rationale for Bank Involvement

13. The proposed operation focuses on structural reforms that are aimed at restoring the viability of the electric power sector. Distractions on the political and security front slowed the pace of reform in the latter part of 2014, but momentum is again picking up. The government has developed an ambitious power sector privatization program, which underlines the need for further structural reforms that will develop a competitive market and improve transparency. In turn sector performance will improve, particularly from reduced losses, raised collections, lower cost of supply and further investment. The Extended Fund Facility (EFF) agreed with the IMF early in the government's term, and complementary support by a significant group of donors has underpinned the authorities' resolve and capacity to deliver. The operation is expected to support faster economic growth, focus government subsidies on the poor and help set the sector onto a more environmentally sustainable path.

14. The proposed operation supports the World Bank's twin goals of poverty reduction and shared prosperity. The Country Partnership Strategy (CPS) for 2015-2019 recognizes the importance of energy by devoting one pillar exclusively to it. A better performing sector benefits all consumers at all levels of the economy and the shortages of energy are widely recognized to have held back Pakistan's economic performance. Increased supply at competitive prices supports economic growth for all enterprises that use electricity, regardless of size or sector and is especially important given Pakistan's dependence on manufacturing and services. A sector which requires less subsidy and has fewer contingent liabilities creates fiscal space for more poverty-targeted interventions.

15. The operation faces high risks. Past efforts at reform of the power sector have stalled in the face of vested interests within the sector and government indifference. The current government has done well so far, but there remains a risk of slowing down or reversal of reforms, especially if public fatigue or resentment sets in when shortages mount in the critical summer months. Resistance to change within the sector, especially if it increases individual accountability in companies and among consumers who benefit from the current weak governance, presents a major risk to achieving the operation's objectives.

IV. Tentative Financing

Source:	($m.)
BORROWER/RECIPIENT	0

International Development Association (IDA)		500
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	500

V. Institutional and Implementation Arrangements

16. Program monitoring is an integral part of the operation. A lesson learned from past energy policy lending is that solid monitoring and evaluation must be integrated into the policy dialogue. For this reason, establishment of delivery units in MWP and MPNR with terms of reference to include monitoring of the energy sector reform, quarterly reporting and public disclosure was included as a prior action in the First Power Sector Reform DPC (DPC-1). Those units produced their first quarterly report in December 2014, which was reviewed by the ECC. Staffing is to be expanded to include full time specialized consultants. In addition, consultants contracted by the Bank and financed by trust funds are supporting the work of the delivery units. They have the capacity to evaluate and advise on issues arising in the sector and bring relevant international experience. JICA is supporting the establishment of the monitoring units and advisors with technical assistance and it is expected that this task will be taken over by ADB funded consultants in due course.

17. Monitoring will be conducted jointly with government and cofinanciers. Ministry of Finance, cofinanciers including ADB and JICA, and the Bank will jointly monitor implementation. Formal review meetings will take place quarterly during the program's lifetime, and will be aimed to coincide with the IMF's quarterly reviews. Reviews will be based on the monitoring reports of the Delivery Units, but will also involve other agents, including NEPRA; the Economic Affairs Department of the government has indicated its intention to participate.

VI. Risks and Risk Mitigation

18. The operation faces high risks. Past efforts at reform of the power sector have stalled in the face of vested interests within the sector and government indifference. The current government has done well so far, but there remains a risk of slowing down or reversal of reforms, especially if public fatigue or resentment sets in when shortages mount in the critical summer months. Resistance to change within the sector, especially if it increases individual accountability in companies and among consumers who benefit from the current weak governance, presents a major risk to achieving the operation's objectives.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impact

1. The poor will be affected in three ways. The poverty and social impact analysis (PSIA) carried out in support of the proposed operation models the subsidy reduction as an increase in the final electricity prices paid by consumers. The first way in which the poor are affected is through tariff increases, by which some poor households which consume more than 200kWh/month in grid electricity will see their bills increase. Second, the price of other consumption goods that have some component of electricity in their cost will increase, negatively affecting all poor households in the country. Third, counterbalancing these short-term negative impacts, the broader reform process will improve the reliability, quality and quantity of electricity supply bringing better employment prospects as the economy picks up. Moreover

quality of life for the connected poor will improve as load shedding tends to affect them disproportionately. Those not yet connected, who are overwhelmingly poor, will have improved prospects of connection to the grid.

2. An across the board tariff increase will be progressive, but have a significant effect on the poor. If government continues to reduce residential subsidies sufficiently to reach the 0.4 percent of GDP target in FY15/16, the poorest two income quintiles are expected to see an overall 1.6 percent increase in their cost of living by then relative to the counterfactual that the program of subsidy reductions from FY12/13 onwards had never taken place.

3. Although the first round of increases has not affected the consumers of smaller amounts of power, some poor people will have been affected because there is only a weak correlation between poverty and electricity consumption. The government has stated its intention to target electricity subsidies to the poorest 20 percent of the population. The Fiscally Sustainable and Inclusive Growth DPC supports reforms to the BISP, including increases in cash payments. While the one-off increase in the cash payment has compensated BISP beneficiary households for the full impact of the electricity price increases, it will not insulate them against future rises in electricity tariffs.

Environment Aspects

4. There are no significant environmental consequences of the prior actions. Prior action 1, reduction of subsidies in the current FY, can only have a positive impact. Normally, reduction of subsidies would increase tariffs to consumers who would in aggregate reduce consumption. Because the extent of current power shortages is so great, it is likely that other consumers would readily take up that decline. At worst, therefore, aggregate generation would not change, and no environmental consequences would follow. The other seven prior actions are directed towards improving the efficiency and financial health of the sector: though specific environmental consequences would be hard to identify and assess.

5. The reform program is a significant step to setting the power sector on a more environmentally sustainable path. he analysis is based on an energy balance model that permits the calculation of economic and environmental impacts on a consistent basis. It investigates the three policy actions which have quantifiable environment impacts: reducing subsidies and improving their targeting to the poor; improving sector performance by loss reduction and improving Disco collection rates; and increasing gas supply to generation. In addition, it takes into account two other objectives of the government: introduction of least-cost generation planning; and improving demand side efficiency. By 2020, these policy actions are expected to displace 11,906 GWh/year of oil fired generation and supply an additional 17,817 GWh/year of energy to the grid, representing an increase of 11.7 percent compared with no actions. An additional 15,026 GWh of energy will be supplied to end users, a 12.4 percent increase compared with no actions.

VIII. Contact Points

World Bank

Contact: Richard Spencer
Title: Lead Energy Specialist
Tel: +92 51 9090209
Email: Rspencer@worldbank.org

Location: Islamabad, Pakistan

Borrower
Contact: Dr. Waqar Masood Khan
Title: Secretary Finance
Tel: +92 51 921 1168

IX. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop