



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

OFFICIAL  
DOCUMENTS

CR = 5740-PK

No. 1(4)EFC/2014

**ISLAMABAD**  
8<sup>th</sup> October, 2015

Dear President Kim,

The government continues to pursue its long term strategy to restore macro-economic stability to Pakistan and improve its economic growth. This foundation of the government's effort has begun to bear fruit and we wish to maintain the momentum of the programme especially with respect to:

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

Our efforts in the energy sector remain central to this programme, and its reform will directly impact the overall economic growth of Pakistan. Through this letter we wish to inform you of the progress of the Government of Pakistan's energy sector reform programme and our plans for the future. Our focus has been the development of a credible and actionable programme 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**

We inherited severe economic imbalances and vulnerabilities in May 2013. In the previous five years, economic growth had averaged 3 percent, well below potential and about half its average of past decades, and inflation was running at about 11.8 percent. By end-June 2013, State Bank of Pakistan's (SBP's) international reserves had dropped to around 1.5 months of imports; investment to GDP ratio had fallen to 15.0 percent; tax to GDP ratio had declined to 9.8 percent while the fiscal deficit was 8.8 percent of GDP. Public debt was well above the 60 percent advised by Pakistani legislation, with some international analysts even suggesting Pakistan would default.

Our democratic transition in May 2013 went a long way to support the implementation of effective measures to address Pakistan's challenging economic situation. As a result of our reform efforts and initiatives, we have been able to make considerable progress in restoring macroeconomic stability. During the fiscal year ending June 30, 2015 (FY15), growth continued to pick up and reached 4.24 percent.

Favoured by low international oil prices, inflation ended last year at 4.53 percent; the fiscal deficit was contained at 5.37 percent; public debt declined; and the external current account deficit was below one percent, while international reserves stood at 3.4 months of imports in June 2015.

The results that have been achieved include:

- Pakistan has successfully completed eight reviews under the \$6.64 billion Extended Fund Facility (EFF) Program of the International Monetary Fund.
- Pakistan successfully re-entered international capital markets after an absence of seven years by issuing Euro Bonds worth \$2 billion and issued Islamic paper, Sukuk, for \$ 1 billion. Recently, Pakistan has successfully issued Euro Bonds worth \$500 million in difficult market conditions.
- We have resumed the privatisation programme, and have already divested the shares of United Bank Limited (about \$400 million), Pakistan Petroleum Limited (subscription of PKR 30 billion, the highest in our stock market's history) and Habib Bank Limited, raising over \$ 1 billion (the largest ever equity offering in an Asian frontier market). We have also completed the first strategic sale, of 88% percent of the shares in National Power Construction Company, raising \$ 25 million.
- We have auctioned 3G-4G spectrum licenses. Against the target of PKR 50-79 billion set during the last five years, we aimed to raise PKR 120 billion from auctions in our government's first full financial year, FY14, and our target was achieved.
- Moody's and Standard and Poor's (S&P) have both raised their outlook on Pakistan's dollar bond from stable to positive. Likewise, Fitch also rated Pakistan for the first time and assigned a rating of B, which is a notch higher than the equivalent rating of S&P and Moody's.

We are improving tax compliance and enforcement to bring more people into the net and also broadening the coverage of other taxes, including General Sales Tax. We have circumscribed the Federal Board of Revenue and government's ability to issue Statutory Regulatory Orders (SROs) to grant tax exemptions and concessions. We are also collaborating closely with the provinces to ensure their contribution to improved fiscal management. We have curtailed government borrowing from SBP and remain within targets agreed with IMF and, as noted above, have diversified our financing in the domestic and international financial markets.

Pakistan's electricity sector, which is a pivotal contributor to the overall economic situation, was facing a severe crisis in June 2013. Despite tariff increases revenues were still falling short of costs, and the Government subsidized electricity to the tune of about 1.8 percent of GDP in FY13. Chronic electricity shortages, peaking at an estimated level of over 7,000MW in 2013 contributed to reduced economic output. The circular debt had reached PKR 503 billion in mid-2013. The underlying cause of this problem was, and to a large extent remains, our over-dependence on the expensive imported heavy fuel oil



and diesel used for generation. Additional factors that affected the availability of electricity for consumption were high levels of losses and theft, and poor equipment maintenance.

In the past two years we have overseen significant improvements in the financial and technical performance of the electricity sector. By virtue of significant tariff increases in August and October 2013, subsidies were substantially reduced for industrial, commercial and bulk consumers and households using more than 300 kilowatt hours (kWh) per month. With the introduction of surcharges aimed at recovering some costs disallowed from the tariff, we further reduced subsidies in FY15 to 0.8 percent of GDP. We introduced performance contracts for the Boards and management of the distribution companies (Discos) and enforced the targets contained in them. At the end of FY15, losses had stabilized at around 18.7 percent, and collections had edged up to 89.2 percent. We have enforced merit order dispatch of power generation plants, pushing down the cost of generation and the increased generation thus enabled, plus new plant additions, means that we have been able to keep up with demand growth: last year the average daily shortfall was 2,900MW compared with 3,800MW in FY14 and 4,000MW in the year before that. This has allowed us to reduce load shedding to six hours in urban areas and eight in rural areas, while also supplying more electricity to industry.

There is still more to do. Technical losses and theft remain higher than acceptable. The circular debt has re-emerged despite our payment of PKR 480 billion in June and July 2013, because revenues from sales to consumers and subsidies from government do not cover the full cost of supply. Load shedding needs to be further brought down by making sufficient inroads into the generation deficit and strengthening transmission system. We continue to bring significant additional finance from private and public sources to support the much-needed investment in electricity infrastructure that will improve supply and bring down costs.

## **II. OUR PROGRAMME**

Let me start this section on our programme by reiterating the basic tenets of our government's vision for Pakistan. First, we want to build an economy that is not dependent on others except through trade and investment, and based on competitive advantage and market considerations. This can only be achieved with rapid and sustained growth. Second, the private sector has to be the lynchpin of economic activity. Third, the only areas where the government's presence in economic affairs can be justified are where investments are too large or too risky for the private sector to undertake, or where markets are unlikely to function, or both. Fourth, everyone must share the burdens of revenue mobilization and enjoy the benefits of reforms. The distortive and inequitable culture of exemptions and concessions must end, and provinces should also be encouraged to participate in this effort. Fifth, government must limit itself to the resources available, aiming for their efficient use and respecting fiscal discipline. Last, we must protect the poor and vulnerable with an accessible and reliable social safety net.

A handwritten signature in black ink, appearing to be 'P. M. Khan', written over a circular scribble.

## **A. Macroeconomic Stabilization**

Pakistan was unfortunately unable to introduce structural reforms for macroeconomic stability and growth during the last one decade, which led to macroeconomic instability when the present government took office. However, since the government took office in June 2013, we have introduced a number of deep-rooted and comprehensive structural reforms and undertaken numerous stabilization measures while protecting vulnerable segments of the society. As a result, Pakistan not only averted the predicted default but is now firmly on the path of stability and growth.

Improvements in Pakistan's economy are manifested by an overall improvement in macroeconomic indicators. In FY14, Pakistan achieved, as mentioned above, GDP growth of 4.02 percent - the highest in six years - and increased it further to 4.24 percent in FY15, reaching the highest level in seven years. The fiscal deficit which stood at 8.2 percent (8.8 percent when the government took office) at the end of FY13 has been brought down to 5.37 percent in FY15. There has also been a significant increase in Pakistan's foreign exchange reserves in the past 18 months. Having touched the predicted low level of less than \$8 billion in February 2014, Pakistan's reserves have continued to grow due to our serious efforts and have now reached the record level of over \$20 billion. Positive macroeconomic performance has resulted in a soaring stock market and increased investment.

Going forward, we will continue to make serious efforts to further consolidate the macroeconomic gains. As committed under the IMF EFF programme, our monetary and exchange rate policies will continue to reduce external vulnerabilities by building foreign exchange reserves. We will maintain a prudent monetary stance, to meet continued expectations of low inflation. Improving monetary operations will help make our policy tools more effective, including enhancing SBP independence.

In this present fiscal year, FY16, we strive for 5.5 percent growth. The current account deficit is expected to narrow to about 0.5 percent of GDP, and inflation is expected to stay contained at under six percent. We continue to work to improve tax collection and aim to achieve a tax to GDP ratio of 12.0 percent this year. We are working to strengthen financial stability through various measures including the introduction of deposit protection, introduction of improved capital and liquidity standards in banks and by strengthening regulatory powers. Our privatisation programme will further build our reserves, with a particular concentration on strategic sales of electricity generation and distribution companies, scheduled for FY16 and beyond.

The banking sector remains sound, and we are committed to ensuring financial stability. We are introducing deposit insurance and strengthening measures to prevent money laundering and the financing of terrorism. We are reinforcing the regulatory and supervisory framework through a strong legislative agenda that will see the introduction of a Securities Bill, the Securities and Exchange Commission of Pakistan Act and a Futures Trading Bill as well as



improvements to existing legislation to help improve recovery of non-performing loans.

The energy sector, by virtue of its influence on Pakistan's economic performance, has been identified as one which can significantly affect macroeconomic stability and fiscal performance. Our plans for the sector are discussed further in subsequent sections.

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

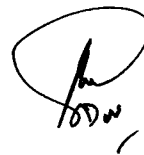
In July 2013, within three months of taking office, we announced a National Power Policy, 2013.

The key goals and targets envisioned under the Policy include:

Goals	<p>To enhance generation capacity in a sustainable manner</p> <p>Promote and ensure a culture of conservation and responsibility</p> <p>Ensure affordable electricity, based (where possible) on indigenous fuels</p> <p>Minimize losses (technical, financial) and inefficiency</p> <p>Control pilferage and theft, and</p> <p>Align the sector ministries, provincial and federal authorities, regulators, and implementing entities, to coordinate activities, and strengthen governance</p>
Targets – to be achieved by 2017	<p>Decrease/eliminate the demand/supply gap – 4500 - 5000 MW today to 0 by end 2017</p> <p>Decrease weighted average generation cost from about USc 12/kWh today, to below 10 USc per kWh</p> <p>Reduce transmission and distribution losses from 23-25% today to about 16%</p> <p>Increase collection rates from 85% (system wide) to above 95%, and</p> <p>Reduce decision times for the Government, related departments, regulators, etc.</p>

In September 2013, the Government prepared a detailed plan aimed at turning this vision into an actionable programme. Subsequently, the programme 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 programme was identified, i.e.

- Supporting the implementation of the Government's policies;
- Ensuring that public sector counterparts and utilities meet their obligations for various projects and programmes; and
- 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**

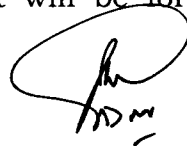
We attribute the positive results in the sector that we have described above in large part to the reform programme which was supported under the first phase of programme lending approved in April and May 2014. We wish to maintain this program and look to the continued support of the three institutions (WB, ADB and JICA) through the proposed second phase of programme lending. In this next phase, the reform programme is aimed at continuing to improve the financial viability of the power sector but also in bringing about lasting structural reform that will encourage improved service and additional investment. It involves a three pronged strategy, i.e.

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

#### ***Managing Tariffs and Subsidies***

We decreased government subsidies for electricity consumption from 1.8 percent of GDP in FY13 to 1.3 percent in FY14 and to 0.8 percent in FY15, slightly above our original target of 0.7 percent. Subsidies remain now only for households which use less than 300 kWh/month, certain classes of consumers including those in Federally Administered Tribal Areas (FATA), Balochistan and some bulk power consumers. We have also eliminated the subsidy mechanism that was used to finance the uniform tariff policy through the introduction of a surcharge as permitted under the Regulation of Electricity Generation, Transmission and Distribution Act of 1997. The government's right to raise surcharges has been challenged in the Courts, but we are confident that we will be able to continue to raise surcharges in the future. We will further reduce subsidies to the electricity sector to 0.4 percent in FY16, as committed to in the IMF programme. We will also take steps to ensure that the remaining subsidies are focused on the poor.

Following the policy issued by government in early 2014, the National Electric Power Regulatory Authority (NEPRA) introduced guidelines for determination of tariffs which sets out the methodology and timetable for the introduction of multiyear tariffs (MYTs). We will stage the introduction of MYTs for all Discos over the coming three years. Because MYTs are a pre-requisite for their privatisation, we are taking steps to ensure that those Discos which are at the top of the government's list submit MYT petitions as soon as possible. Faisalabad and Peshawar Electric Supply Companies (FESCO and PESCO respectively) have already done so, and NEPRA has held its hearing for the FESCO petition. Islamabad and Lahore Electric Supply Companies (IESCO and LESCO respectively) will submit [five year] MYTs in FY16. The MYT will bring stability to tariff determination and in the five year tariff period, adjustment will be formula-based and therefore much quicker.



Despite our efforts to improve financial viability of the Discos, there is still a shortfall between the combination of revenues from sales to consumers and subsidies provided by the government on the one hand, and the cost of running the system on the other. The shortfall gives rise to the circular debt and is caused by a number of factors, including:

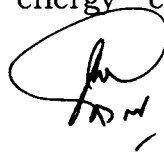
- Sector inefficiencies arising from Discos having higher levels of losses and lower levels of collections than those allowed by the Regulator;
- Discrepancies in the tariff regime that does not recognize some costs, including the cost of delays in determination of new tariffs;
- Some costs are imposed on the Discos by virtue of government policy, including subsidies, and failure by Federal and Provincial government departments to pay their bills.

In consequence, the circular debt – defined as the aggregate amount of payables owed by the Discos on the last day of any given month – started to re-emerge from August 2013. It had reached PKR 314 billion at the end of FY15, and experience indicates that beyond this level the ability of the sector to produce electricity is reduced. We have, therefore, imposed a cap on the circular debt and prepared a plan to manage it, which we have published on the Ministry of Water and Power web site. The three-year plan has been endorsed by the Economic Committee of the Cabinet (ECC) which will also monitor it, and publish the findings of the monitoring. The plan and our monitoring is also an important part of maintaining our commitment to IMF under the EFF programme.

Our circular debt management plan is fully funded to allow the reduction of the flows to PKR 39 billion by the end of FY18, and to manage the stock from its current level down to PKR 212 billion by the same date. In addition, we have also introduced a surcharge to cover the cost of servicing historic circular debt held in the Power Holding Company which currently amounts to PKR 335 billion. We rely on privatization proceeds to reduce the stocks of both current and historic circular debt. We will monitor the progress of the plan and provide support as required to cover the costs of the management plan throughout the remainder of this Parliament.

### ***Improving Sector Performance and Opening the Market to Private Participation***

We have identified three areas of action on which our program efforts will focus to improve the performance of the sector. The first is to address efficiency of machinery and appliances, on both the supply and the demand side, and thus ensure we extract maximum value from our investments in the electricity sector. To that end, after approval from the Council of Common Interest (CCI), we have placed the Energy Efficiency and Conservation Bill before Parliament and expect it to become law in early 2016. We have issued the guidelines on minimum energy performance standards, and energy labelling requirements for three consumption intensive appliances and in the near future we will introduce a fiscal incentive to promote energy efficiency and conservation.

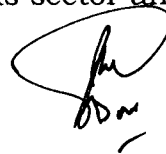


On the supply side, the lack of focus on selection of least cost generation projects, and the failure to optimize generation and transmission investments has contributed toward the high cost of supply. We are well advanced in the preparation of a generation and transmission long-term least-cost plan to ensure that only those projects are considered for implementation which take 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. We will ensure that least-cost plan is submitted to NEPRA during FY16. Thereafter we will ensure rigorous implementation of the plan and will not finance in the public sector, or approve investments by the private sector that does not feature in the least cost plan. We will also adhere to the retirement schedule in the plan, so that old and inefficient plants are taken out of service and replaced with modern, efficient and reliable plants.

The second area where we are focusing our efforts is in the gas sector. We recognize the importance of natural gas to the power sector as well as to other key industries. Domestically-produced gas is a readily-available, comparatively inexpensive and environmentally-friendly fuel for electricity generators. We are making efforts to ensure that exploration and production of gas in Pakistan has adequate incentives, and have awarded 46 new concessions for exploration and production of domestic gas in August 2013. Simultaneously, we adopted a model supplementary agreement that gives better prices to existing concessions. Since completing the DPC prior action in June 2015, we have converted a further two gas concessions bringing the total to 94 existing agreements of 120 that applied and were eligible for the new prices under the 2012 Petroleum Policy. In the coming year we will start amendments to the concession agreements to provide 2012 policy prices to incremental gas produced from existing concessions. In the medium term we will review the results achieved under the 2012 policy with a view to making the domestic gas sector more attractive to private capital.

To supplement our domestic supplies, we started importing liquefied natural gas (LNG) in April 2015 and have adopted a policy of cost recovery in the gas sector. We have defined those consumers who are eligible to receive LNG, namely power generation, bulk consumers, fertilizer production and compressed natural gas, since these are the ones that are able to extract the maximum economic value from gas. We have also mandated that these users of LNG will pay the full cost of the gas. No LNG will be added to the pool of domestic production and no consumer which does not pay the full cost of LNG will be supplied it.

In the medium term we intend to move towards a more market-oriented gas sector and away from the administrative allocations of gas and controlled pricing of today. This will be essential if we are to be able to attract further imports, whether via LNG or pipeline from our neighbours. As a first step in this direction, we have started a review of the structure of the middle and downstream gas sector and will adopt a

A handwritten signature in black ink, appearing to be 'J. Khan', is located at the bottom right of the page.



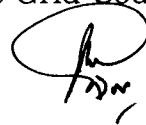
restructuring plan in FY16. With the restructuring plan we will also prepare for the privatization of the gas distribution segment.

It is to the third area of power sector reform that we have devoted our largest effort and achieved the most significant change. We are poised for a significant transition, which has evaded previous governments for the past 15 years. We have set up the Central Power Purchasing Agency Guarantee (CPPA-G) independent from NTDC. Although initially CPPA-G will act as an agent of Discos, it is intended to develop competitive markets following policies set by government and requirements set by NEPRA. To make CPPA-G operational, NEPRA has approved the modification of NTDC license so that it can no longer buy or sell power. The Market Operator Registration Standards and Procedures Rules have been notified. CPPA-G has prepared a Commercial Code which has been approved by NEPRA and has put in place standard operating procedures that will allow billing and settlement. CPPA-G is charged with market development and as a first step will implement the market for direct contracting between electricity generators and bulk power consumers.

On behalf of the Discos, CPPA-G has signed PPAs with the Gencos. The power purchase agreements (PPAs) with the independent power producers (IPPs) whose agreements fall under the 2002 Power Policy remain to be novated from NTDC to CPPA-G and a new PPA has yet to be agreed between WAPDA Hydel and CPPA-G. We are committed to completing these actions in line with the legally-binding Economic Coordination Committee of the Cabinet's decision of September 4th, 2015 which provides for a transition period after the signing of the Business Transfer Agreement of two years for the 2002 Power Policy IPPs and six months for the WAPDA Hydel PPA. Thereafter we will be in a position to implement the bulk supply market.

In parallel, we are also pressing ahead with the privatisation of the publicly owned Discos and thermal generation companies (Gencos). Privatisation is a key part of our strategy to limit the government's financial liabilities in the electric power sector, including to address the stock of circular debt, and to improve technical performance. Consequently we are working to privatise Discos and Gencos, and have developed a plan to sequence the capital market and pre-privatisation restructuring for these firms. We have already recruited financial advisors for all companies and we expect to close the first transaction within FY16 and expect to complete the privatization of all Discos and Gencos within the term of the current government.

We recognize that during the remaining period in public ownership, and to make the power companies more attractive, we have introduced performance driven contracts for the public sector utilities, signed by the Board and management of each company and Ministry of Water and Power. The Discos are being instructed to implement the requirements of the Companies' Ordinance 1984. We have introduced a mechanism to monitor the utilities' performance under these contracts with reporting to the Economic Coordination Committee of the Cabinet on performance. NEPRA has signalled its intention to ensure implementation and compliance with the Grid Code.



### ***Improving Accountability and Transparency***

The status of follow up actions under the Petroleum Exploration and Production Policy 2012 actions under the National Power Policy, 2013 are being monitored regularly by the ECC of the Federal Cabinet. Review at the highest level demonstrates the importance which the government attaches to implementing the energy sector reform plan.

We have established a mechanism for quarterly monitoring of the power and petroleum policies set out in this letter. We have established monitoring units in Ministry of Water and Power and Ministry of Petroleum and Natural Resources charged with monitoring of the progress of the reforms, reporting to the ECC on a quarterly basis, and disseminating energy sector information to the public. We will also hire monitoring consultants to work with the units in MWP and MPNR through donor funding. 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. As a first step we have appointed a new Chairman of NEPRA and a Member with financial skills. 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. We have also publicly made available on the CPPA-G website the monthly amounts due and payments made by Discos and to generators.

We will implement public web-based information about the performance of Discos, Gencos and NTDC against the benchmarks set in their contracts. NEPRA has published its review of the performance of Discos on its website; Discos have published their own annual performance reports on their websites. We will further strengthen the two monitoring units at MWP and MPNR and upgrade their outreach capacity to move beyond passive publication and towards a more proactive approach to communications with the public. We are strongly committed to ensuring that all the information we publish is kept up to date: quarterly reports will be available within one month of the end of the quarter, and annual reports within six months of the end of the year.

### **III. GOVERNMENT COMMITMENT**

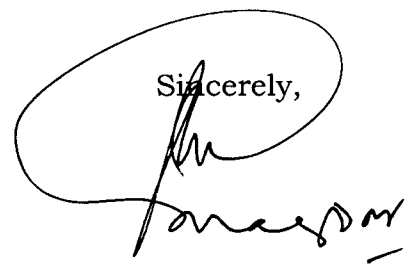
We take this opportunity to reiterate our commitment to reforms and dealing with the policy issues. We have already taken some difficult decisions including substantial tariff increases and the settlement to the power sector circular debt which are already yielding positive results. We are committed 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 programme 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,  


Dr. Jim Yong Kim,  
President,  
The World Bank,  
Washington.