FINANCIAL MANAGEMENT ASSESSMENT

A. INTRODUCTION

1. A financial management assessment (FMA) for Pakhtunkhwa Energy Development Organization (PEDO),[1] the project implementing agency, was conducted as part of preparation for the Balakot Hydropower Development Project (the project) in accordance with Asian Development Bank's (ADB) *Financial Management and Analysis of Projects* (2005).[2] The FMA examines the financial management systems including accounting policies and procedures, internal and external audit functions, financial reporting and monitoring, and information systems of PEDO.

B. COUNTRY AND SECTOR FINANCIAL MANAGEMENT ISSUES

2. The overall fiduciary risk at the federal level is assessed to be medium to high with some positive progress observed within individual Public Expenditure and Financial Accountability Assessment dimensions. Federal government over the years has made some improvements in the overall budget management. Budgeting, reporting, and introduction of medium-term planning tools and use of a risk-based audit methodology by the office of the Auditor General of Pakistan (AGP) are some of the key reforms implemented over the past few years.

3. The Public Expenditure and Financial Accountability Assessment 2012 noted that the predictability of the aggregate expenditure over 3 years has shown considerable improvements for Federal Government moving from a 'D' to a 'B.' Issues remain at the disaggregated level for expenditures, where high deviations were common, pointing to substantial re-appropriations under individual expenditure heads. This is mainly due to economic slow-down caused by floods and additional expenditure on maintenance of law and order, debt servicing, inflation, and economic instability, which contributed to fiscal constraints. The government made frequent use of supplementary budgets and re-appropriation with ex-post approval by the legislature. While this is allowed by the constitution, the extensive changes undermine credibility of the budget. The complete roll-out of the Medium-Term Budgeting Framework (MTBF) to all ministries largely contributed towards improvement in ratings. Sector strategies are in place and preparation of a Budget Strategy Paper and the MTBF allows timely communication of indicative budget ceilings to the line ministries. However, linkages between multi-year estimates in MTBF and annual budgetary ceilings need to be improved with adequate explanation and documentation.

4. Pakistan's National Power Policy (2013) is a key government document promoting generation from low cost sources and adding around 29,000 MWs by 2021.[3] In line with the National Power Policy, ADB supports the government in (i) tariff reforms for a self-sustaining regime and better targeting of subsidies to low-income consumers; (ii) loss reduction and larger tariff collections by electricity distribution companies; (iii) stronger demand-side efficiency and energy conservation measures; (iv) instituting performance-based contracts and increasing public access to information on generation, consumption, tariffs, and subsidies through web-based disclosure; and (v) commercializing and privatizing electricity distribution companies.

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[1] PEDO, previously known as Pakhtunkhwa Hydel Development Organization (PHYDO), is an energy development organization of the Khyber Pakhtunkhwa (KPK) Government.
[2] ADB. 2005. *Financial Management and Analysis of Projects*. Manila.
[3] Government of Pakistan. 2013. *National Power Policy 2013*. Islamabad.

5. As a result of merger of water and power and petroleum and natural resources commissions in 2017, the Ministry of Energy is established for power administration and energy sector reforms. Power generation, transmission and distribution tariff settings are determined by the National Electric Power Regulatory Authority (NEPRA). This is a comprehensive process taking on average about a year including preparation and submission of tariff petition to NEPRA, public hearing, validation and issuing notification. All risks associated by the project planning, procurement, and regulatory approval are owned by the project developer, i.e. PEDO. Other power-sector-related agencies are the Planning Commission, which carries out energy integrated planning and Private Power and Infrastructure Board (PPIB), which leads the licensing of independent private producers (IPPs).

6. To comply with its market reforms objectives, the Central Power Purchasing Agency Guarantee Limited (CPPA-G) has been separated from the National Transmission and Dispatch Company (NTDC) and acting as single-buyer on behalf of ten distribution companies. CPPA-G is also responsible for financial settlement and billing between the generating companies and DISCOs. Decoupling market operations from NTDC has significantly reduced the liquidity risk for market participants, including PEDO. CPPA-G has been mandated to establish a Comprehensive Competitive Trading Bilateral Contract Market and transition to a wholesale power market by 2020 to bring in competition, transparency, and financial discipline in the power sector.

7. Circular debt is a major issue confronting Pakistan's energy sector. It is a shortfall at CPPA-G of cash inflows from DISCOs and outflows to power suppliers due to (i) inadequate tariff and subsidy systems calibration, and (ii) technical and operational inefficiencies (technical losses). The delayed payments to IPPs made the matter worse as they were paid late payment surcharge at the rate of 11% per annum further adding to the deficit. Furthermore, the delay between the determination of the tariff by NEPRA and the notification of the tariff by the government has increased the gap between the cost of supply and the billed amounts to end users, which the government identified as the main contributor for circular debt growth. While the collections are not fully recovered by DISCOs, taxes are still raised on non-recovered amounts increasing the sectoral liabilities. Consequently, the circular debt reached almost $9 billion by mid-2018. ADB's ongoing programs and TA activities are in place to support the government's efforts in mitigating circular debt risk through a set of comprehensive sector and institutional reforms.[4]

C. ACCOUNTING, FINANCIAL REPORTING IN PAKISTAN

8. The government adopted the International Public Sector Accounting Standards (IPSAS) on a cash accounting basis for public sector and government funded entities. The AGP follows the International Standards of Supreme Audit Institutions (ISSAI). The Government of Pakistan operates budgeting and accounting classification system under the New Accounting Model (NAM) introduced in fiscal year (FY) 2005 that complies with international classification standards (namely the United Nations Classification of Functions of Government), which enables more accurate, detailed, adequate and transparent accounting, reporting and effective budget monitoring.[5] The use of centralized financial accounting and budget system, application of the NAM and capacity building of accounting staff supported by donors have strengthened financial reporting both at federal and provincial government levels. Use of a uniform chart of accounts for

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4 ADB. 2019. *Report and Recommendations of the President to the Board of Directors.* Proposed Programmatic Approach and Policy Based Loan for Subprogram 1 to the Islamic Republic of Pakistan for Energy Sector Reforms and Financial Sustainability Program. Manila.

5 NAM is based on a cash basis of accounting and encompasses commitment accounting, fixed asset accounting, assets register and new Chart of Accounts.

capital budgeting at federal, provincial and district level enables uniform classification of data and direct comparison with the original budget, capital investment and estimates.

D. AUDITING AND INTERNAL CONTROL IN PAKISTAN

9. Significant improvements have been made in the timing of external audit. The AGP has established a deadline of 28 February each year for submission of audit reports of the previous financial year (which ends 30 June). The AGP submits audit reports to the governor of the respective province, who submits it to the provincial assembly. The external audit is conducted using International Organization of Supreme Audit Institutions auditing standards. Constitutional protections regarding the tenure and procedures for removal of the AGP ensures the independence of the office and an objective assessment of the quality of public expenditure and management of public assets. The AGP will be responsible for external audit of the ADB funded project and PEDO annual financial accounts.

10. The government's internal expenditure control system is based on a series of regulations, including the NAM, Financial Rules, Treasury Rules, Delegation of Financial Powers and Rules of Business.[6] Internal controls on capital budgets are regulated by FABS that centralizes all disbursements via bank accounts. Internal control for capital investments is strong in terms of control over expenditure commitments, but less effective in the terms of comprehensiveness, relevance and rules and procedures. Weaknesses include (i) inadequate decision-making authorization at the operational level (usually consisting of a junior official at the drawing and disbursement office), (ii) ineffective asset management, (iii) untimely surrender of excess budgetary allocations, (iv) acceptance of incomplete works and payments thereof, and (v) incorrect accounting of transactions.[7]

E. FINANCIAL MANAGEMENT ASSESSMENT OF PEDO

11. Established in 1993, the PEDO is a 100% government owned entity to own, manage and operate power generation in the Khyber Pakhtunkhwa (KPK) province of Pakistan. Incorporated as a joint-stock company, PEDO has 6 field offices located in KPK provinces to manage existing power generation and plants under construction. Administered by the Department of Energy and Power of KPK government, PEDO is governed by the Board of Directors that has supervisory function. Under the PEDO Act 2014, all board members are appointed by the KPK government. PEDO's operational strategy and annual business plan is aligned with KPK Hydropower Policy's (2016) objectives including promoting private sector investments and support for development of energy mix in KPK province. At present, PEDO's generation fleet comprise 7 hydropower plants with total available capacity of 161 MW and 5 hydropower plants under construction with total capacity of 215 MW. PEDO's corporate model and hydropower plants data is provided in Appendix 1.

12. **The strengths of the PEDO** include: (a) long history of development experience in construction and operating of HPPs; (b) experienced technical staff; (c) investment planning and funding support from the federal and provincial government; (d) financial transparency and external audit by the Audit General of Pakistan and an independent audit firm. **The weaknesses of the PEDO** are (a) existing financial management system not in line with corporate structure and private sector development mandate; (b) absence of accrual-based reporting and automated

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[6] Rules of Business. 1973.

[7] ADB. 2016. *Technical Assistance to the Islamic Republic of Pakistan for Access to Clean Energy Investment Project* - Fiduciary Systems and Risk Assessment Report. Manila (TA 9047-PAK).

accounting; (c) high degree of dependence on management consultants rather than building its internal capacity for quality assurance and project management.

1. Institutional Arrangements

13. Led by the CFO, the Accounting and Finance Division of PEDO is responsible for the financial reporting, investment planning and capital budgeting of the company. PEDO's accounting is adequately staffed for the fulfillment of basic reporting requirement under the federal and provincial requirements. Reporting to the CFO and Financial Controller, 3 locally qualified accountants are in charge of dealing with daily accounting operations. There is a separate division supporting implementation of capital projects with respect to disbursements, expenditure management, budget, recording, and project accounting, preparation of tariff petition, monitoring and reporting. Accounting and finance staff benefit from external training and capacity development programs funded by PEDO and provincial government. At present PEDO prepares all its accounts under cash basis complying with federal reporting standards and developing IFRS adoption to be enacted in 2020.

2. Accounting Policies & Procedures and Financial Reporting & Monitoring

14. PEDO's accounting and financial reporting is on cash-basis and in compliance with IPSAS. Financial statements are prepared on annual basis and complied with statutory reporting standards by the federal government. PEDO's accounting division is responsible for monthly cash flow statements and monitors cash flows on a daily basis for management control.

15. To comply with its private sector development mandate, PEDO's management approved adoption of accrual based and IFRS compliant reporting by end 2020. The company developed draft accrual accounting policies and procedures verified by PEDO's external auditor and transition plan from cash to accrual reporting for FY2018 accounts. However, PEDO's accounts aggregation is processed mostly manually by and resulted in delays in financial statements' preparation. To improve the quality of accounting practice, PEDO contracted an international consulting firm to support in preparation of annual IFRS-based accounts. Starting from 2021, PEDO will use reconfigured accounting software for automated conversion of cash accounting into accrual reporting under IFRS requirement. The capacity development program under this project and other ADB loan project will seek to strengthen the accounting and reporting systems of the company with the objective to improve its financial management capability. [8]

16. To comply with federal and provincial standards, PEDO maintains all project accounts separately and follows decentralized disbursement verified by Director of Finance and approved by general management of projects. The project invoices are prepared by the respective Project Director and verified by the management consultant. Subsequently, the Accounting Division proceeds with payments and disbursement for the project via corresponding banks. and then disburses it to the contractor. All project documentation and reference documents are archived for a 50-year period in compliance with federal requirements.

17. PEDO's assets and inventories are inspected on annual basis by the asset management commission under the Accounting and Finance Division. The respective divisions of PEDO are responsible for managing property and preparing effective usage and property protection

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8 ADB. 2006. *Pakistan: Renewable Energy Development Sector Investment Program - Project I*. Manila (Loan Nos. 2286 and 2287).

measures in compliance with federal and provincial requirements. All PEDO's assets including hydropower plants are insured by a local insurance firm underwritten by international reinsurers. The monitoring records and updates on fixed assets registers are managed by the Accounting and Finance Division and reconciled on a quarterly basis.

18. PEDO has well established cash operation procedures and controls in compliance with IPSAS and government requirements.[9] All banking operations require confirmations by Director of Finance and CFO. In his absence, the CEO's approval is delegated to a Project Director who acts as authorized signatory for the bank accounts. Bank and cash accounts are reconciled on a monthly basis by Director of Finance. All unusual items on the bank reconciliation are reviewed and approved by the CEO and the CFO. The Accounting and Finance Divisions maintains up-to-date cashbooks and general ledger recording receipts and payments, and other accounting transactions on daily basis. The accounting books consist of PEDO's consolidated accounting and detailed projects' accounting ledger. Going forward, PEDO would require additional staff in accounting and finance to perform financial management functions for internationally funded projects.

3. External Audit

19. PEDO's operational and investment projects' audit is carried by the AGP in compliance with federal standards of procurement and reporting. The AGP provides the Observation Letter (equivalent of the Management Letter Point in audit practice) highlighting key weaknesses and deficiencies in the financial reporting and the quality assurance for internal control and procurement. The AGP submits its audit reports to the Secretary of Energy and Power of the KPK province and if the matters highlighted by AGP are unresolved, the audit report is submitted to the Public Accounts Committee of the KPK Provincial Assembly.

20. Under existing legislation, the international standards of audit (ISA) are officially recognized by the federal law and the audit companies are required to apply ISA in audit practice accordingly. Since 2010, PEDO has been also audited by an independent audit firm (Avais Haider Liaquat Nauman, a member firm of RSM Network) for the entity's financial statements in compliance with ISA. The external auditors are selected through a competitive bidding process every year and the terms of reference for annual audits are prepared as per requirements of the KPK Government Regulation. There is statutory requirement to change engaged partner of external audit firms every three years.

21. PEDO's latest entity's audited report is available for FY2017 and qualified for discrepancies in revenue recognition (differences between actual sales revenues and approved tariffs) between PEDO and the regulator.[10] PEDO management confirmed that these qualifications have been in the process of negotiations with respective federal agencies and expected to be fully addressed during PEDO's board meeting.

4. Internal Audit

22. PEDO has a special internal audit unit led by an accountant and five staff members trained in compliance, control and audit. However, the unit does not operate in its full capacity and

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9 Companies Act 2017 formerly Companies Ordinance 1984.

10 Difference between approved tariff (Rs 4.5/kWh) for electricity for Pehur HPP (18 MW or 11% of PEDO generation capacity) and actual payments for its electricity sold at Rs 1/kWh resulted in increasing receivables and associated tax liabilities.

functions. Unlike in corporate sector, the audit unit reports not to supervisory board but governed by Director of Accounting and Finance Division. The scope of audit is limited to financial reporting and investment projects implementation but not monitoring management activities and implementation of audit recommendation at the company level. This practice significantly constrains independency of internal audit and quality of recommendations. To create audit independency and comply with federal legislation,[11] PEDO's supervisory board approved the concept for audit committee to be established under supervisory board comprising both board's members and qualified and independent auditors. The capacity development program under this project and other ADB loan projects (footnote 8) will seek to strengthen PEDO's internal audit and compliance control systems with the objective to comply with the company's approved corporatization plan.[12]

5. Information System

23. PEDO's accounting and reporting system remains very fragmented and mixed of manual bookkeeping and statements prepared in separate electronic spreadsheets. Confidentiality, integrity, and availability of data are maintained under the prescribed PEDO's internal procedures and provincial regulations. An international consulting firm completed design of new business process mapping and configuration. PEDO expects approval and implementation of the new accounting software by 2020. This will significantly improve PEDO's financial accounting, performance reporting and management capacity. With these targeted measures, the financial accounting and management information system is expected to have sufficient capacity for improving the procedures and to achieve significant results or impacts.

6. Risk Assessment and Mitigation Measures

24. Table 1 summarizes risk assessment and proposed mitigation measures.

Table 1: Risk Assessment and Proposed Mitigation Measures

Risk	Risk Assessment	Management Plan and/or Mitigation Measures
1. Inherent risks	Substantial	The project management unit (PMU) to be supported by international consultants. Training on ADB procedures to be provided.
2. Funds flow arrangements	Substantial	ADB direct payment, commitment letters, and reimbursement procedures are to be used for the project. No imprest account will be established. Relending agreement between the Department of Finance and PEDO to be submitted to ADB.
3. Staffing	Substantial	PEDO to be responsible for retaining adequate staffing and timely payment of salaries to staff. Recruitment and training of staff for international financing reporting standards (IFRS) to be implemented by PEDO with the support from international consultant.
4. Accounting policies, procedures, and systems	Substantial	An accounting system to be established and maintained for the project to minimize risk. IT systems diagnostics to be carried out by international consultant to identify the weaknesses and to design mitigation plan including upgrading accounting system and the introduction of Enterprise Resource Planning (ERP) an integrated Management Information System (MIS). Recruitment of or internally trained IFRS accountants to introduce accrual based and IFRS compliant accounting.

11 Government of Pakistan. 2013. *Public Sector Companies (Corporate Governance) Rules, 2013*. Companies Act 2017 formerly known as Companies Ordinance 1984.

12 Corporate Restructuring Plan. ADB. 2010. *Regional Empowering the Poor through Increasing Access to Energy*. Manila (TA 7512-REG).

		Documented procedures and staff training to be provided to retain institutional knowledge.
5. Internal audit	Medium	Engagement of consultants to strengthen critical capacities of internal auditing by providing advisory support and on-the job training for (i) conducting the internal audit of planned ADB financed activities, which will serve as on-the-job training for PEDO's internal audit unit; (ii) monitoring and implementing internal audit and external auditor's recommendations, and (iii) developing capacity in conducting risk-based internal audits
6. External audit	Medium	Loan/Project Agreements require PEDO's financial statements and project financial statements be audited in accordance with international standards on auditing (ISA) by auditor acceptable to ADB. PEDO will submit to ADB audited project financial statements by AGP within 6 months of the end of the fiscal year. PEDO's annual financial statements will be approved by management and supervisory board accordingly.
7. Reporting and monitoring	High	A reporting system, which will have functionality for automatic generation of financial reports to be established and maintained for the project. Implementation consultants will be recruited to assist PMU in supervising the project implementation, recording project costs, preparing withdrawal applications and progress reports.
8. Information systems	High	Information systems and processes to be enhanced to meet the demands of organization, ensure operational stability, and allow for full consolidation of management information as well as financial data. ERP and MIS adoption will improve the information system and reporting transparency and consistency.
Overall	**Substantial**	

25. Based on this assessment, Table 2 presents action plans to improve financial management capacity of PEDO are the following:

Table 2: Financial Management Action Plans for PEDO

Action	Responsibility	Resources	Timing
Development of ERP and MIS to improve accounting infrastructure of the company	PEDO, PMU and IT Department	PEDO's internal resources	2020−2021
Regular training of accounting staff to improve their financial management capacity	PEDO's Finance and Accounting Division	PEDO's internal resources	From the beginning of the project on regular basis
Engagement of reputable external auditors to conduct entity and project account audits	PEDO's Finance and Accounting Division	ADB Loan (this project)	Annually
Engagement of consultants to strengthen critical capacities of internal auditing by providing advisory support and on-the job training for (i) conducting the internal audit of planned ADB financed activities, which will serve as on-the-job training for PEDO's internal audit unit; (ii) monitoring and implementing internal audit and external auditor's recommendations, and (iii) developing capacity in conducting risk-based internal audits;	PEDO's Internal Audit Unit	ADB Loan (this project)	2020−2022

Engagement of consultants to provide project supervision and monitoring and financial management training to clarify ADB requirements including disbursement requirements and financial covenants calculation	PEDO's PMU	ADB Loan (this project)	From the beginning of the project on a regular basis
Engagement of consultants to support implementation of accrual-based and IFRS compliant accounting	PEDO's Finance and Accounting Division	PEDO's internal resources	2019−2020

7. Implementation Plan

26. PEDO has the experience and capacity to manage foreign-funded projects and is already managing ADB-funded energy projects (footnote 8). For this ADB funded project the separate project management unit (PMU) will be created in PEDO for implementing the project according to the legal agreements and other implementation arrangements described in the Project Administration Manual (PAM). Upon effectiveness, a loan account under the Ministry of Finance name will be opened in ADB's books where the loan proceeds will be credited, and further on-lent to the KPK Government. All disbursements will be carried out in accordance with ADB's Loan Disbursement Handbook (2017, as amended from time to time).[13] Implementation consultants will be recruited to assist PMU in supervising the project implementation, recording project costs and preparing withdrawal applications and progress reports. Proposed actions to mitigate the risks at the EA level include a capacity development program to be financed as part of this project and other similar programs under other international loan projects. PMU will be responsible for preparation of annual financial statements for each fiscal year starting with the project's effectiveness and have these audited annually by the AGP.

27. PEDO will be solely responsible for implementing the project according to the legal agreements and will enter into various agreements with state owned agencies for power off-take and tariff payments.

(i) Energy Purchase Agreements (EPA) will be signed with CPPA-G for the evacuation of electricity generated and payments in accordance with approved tariff and applicable indexations as approved by regulator during the term of PPA.
(ii) Water Use Agreement (WUA) will be signed with KPK government for the payment of water use charges as defined under EPA and approved under tariff.
(iii) Engineering Procurement and Construction (EPC) contract will be signed with EPC contractor selected through International Competitive Bidding.
(iv) Operation and Maintenance (O&M) contract will be signed with O&M contractor selected through competitive bidding to run the plant as per national dispatch criterion and regular maintenance activity.

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13 ADB. 2017. *Loan Disbursement Handbook*. Manila.

F. HISTORICAL FINANCIAL STATEMENT ANALYSIS

28. PEDO's accounting and financial performance data have been analysed over the period of 2015–2017 and this assessment is based on the financial statistics constructed on the company's cash reporting following the IPSAS and federal reporting requirements.

29. PEDO's major source of revenue is the sale of electricity generated by its fleet of hydro power plants in the KPK province reported at PRs 2.5 billion in 2018. The company's profitability remains above 55% over the recent years with revenue's annual decrease at average 7% in 2015–2017. PEDO's net profit margin declined by 5% over 2016−2018, however, it still reported positive net profit of PRs 1.5 billion in 2018. The decline in the company's profitability is explained by increasing margin of operating expense. The operation and maintenance (O&M) remained the single largest cost item in operating expenses and increasing from 53% of total expenses in 2014 to 60% in 2015–2017. The summary of PEDO's revenues and expenditures are presented in Table 3.

Table 3: Summary of PEDO's Profit and Losses

(in million PRs)	FY2016	FY2017	FY2018
Revenue from hydroelectric projects	2,523	2,367	2,486
Government grants	-	-	-
Total Revenue	**2,523**	**2,367**	**2,486**
Operational cost	607	674	703
EBITDA	**1,916**	**1,693**	**1,784**
Other income	26	134	71
Depreciation	262	250	305
Earning for the period	**1,680**	**1,577**	**1,550**

EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization, FY = fiscal year, PRs = Pakistan rupee

30. PEDO maintained stable and strong liquidity position with reported cash at PRs 2.5 billion and current ratio above 1. The company heavily benefits from direct equity contribution by provincial government through annual allocation from the Hydel Development Fund and Public Sector Development Allocation. The summary of PEDO cashflow is presented in the Table 4.

Table 4: PEDO's Cash Flow Statements

(in million PRs)	FY2016	FY2017	FY2018
Cash flow from operations	1,645	1,392	2,474
Cash flow from financing	(6,357)	8,060	5,121
Cash flow from investing	(2,708)	(10,253)	(5,413)
Cash generated for the year	**(7,421)**	**(801)**	**2,182**
Cash balance brought forward	8,590	1,181	380
Net cash available	**1,169**	**380**	**2,562**

FY = fiscal year, PRs = Pakistan rupee

31. PEDO has relatively strong capital structure as most of its funding coming from the federal and provincial governments. The company's total asset value expanded at annual average of 14% in 2016−2018 from PRs 24 billion to PRs 40 billion. PEDO's capital (equity) increased at annual average of 19% in the same period. The company's solvency position was very strong with debt-to-equity ratio below 1%. The table 5 summarizes the historical capital structure of PEDO.

Table 5: PEDO's Balance Sheet

(in million PRs)	FY2016	FY2017	FY2018
Fixed Assets	21,720	31,662	36,783
Current Assets	2,485	2,119	3,654
Total Assets	**24,205**	**33,780**	**40,437**
Non-current liabilities	24	24	24
Current Liabilities	91	91	77
Total Liabilities	**115**	**115**	**100**
Projects Equity	19,463	29,271	34,392
Retained Earnings	4,627	4,394	5,944
Total Equity and Liabilities	**24,205**	**33,780**	**40,437**

FY = fiscal year, PRs = Pakistan rupee

G. FINANCIAL STATEMENT PROJECTIONS

32. PEDO's financial projections are modelled on the assumption that the company will maintain its role in developing energy projects in KPK province under its mandate. For this projection, generation growth is based on commencement of 10 power plants with total capacity of 576 MW over the period of 2020-2030 leading to an annualized average generation growth rate of 22.5%. All new capital projects will be built through special purpose vehicles consolidated in PEDO's balance sheet where grants from the federal and provincial governments are considered as equity contribution.[14] PEDO's investment in power projects (hydropower plants) will be amortized over estimated useful life of 35 years. It is assumed that the PPAs will be in place prior to commercial operations for new power plants and PEDO will continue benefiting from the regulatory return on equity as per regulator's approved tariffs for hydropower plants. Annual net profits will be capitalized for development of new capital investments (hydropower plants) projects and no dividends paid in projected period. The summary of projected financial statements and profile of PEDO's capital expenditures up to 2030 are presented in Appendix 2.

33. **Sustainability risk**. Circular debt and liquidity are the major risks of sector sustainability in Pakistan. The government in consultation with development partners, has embarked upon a new reforms program to develop energy sector resilience. The program entails strengthening governance of sector institutions, improving collections, reducing transmission and distribution losses and capacity charges, developing new policies to rationalize pricing, supporting tariff reforms, settlement of long outstanding issues of taxation and tariff disputes and reducing subsidies. PEDO's liquidity position and overall exposure to circular debt is mitigated with KPK government support in timely reconciliation of payments for electricity produced and supplied to national grid. Delays in payment for electricity supplied by PEDO do not exceed 90 days, and PEDO benefits from penalty payments on delayed amount.

34. On the corporate level, PEDO's sustainability is backed by KPK government's support in strengthening the company's corporate governance, management capacity and financial transparency and sustainability. Among most urgent measures, the government prioritizes the empowering supervisory and management boards, adoption of IFRS and implementing advance accounting and reporting system. Loan covenants have been included to address this concern from ADB perspective.

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14 All PEDO's projects benefit from tax benefits (i.e. exemptions for profit tax, turnover tax and withholding tax) in the power sector.

35. On the project level, Balakot HPP’s sustainability will be maintained over the economic life of the project by (i) national tariff settings with tax benefits and monetary incentives by the regulator, and (ii) liquidity support from PEDO and equity contribution from KPK government.

H. FINANCIAL COVENANTS

36. Given existing risks and challenges for PEDO, the following set of financial management covenants are proposed for the project:

a. Audit and risk committees are gathered at least twice in a year under the Board of Directors;
b. IFRS compliant financial reporting adopted by 2021;
c. Debt service coverage ratio at 1.2 or more;
d. Ratio of total operating expense to total operating revenues is less than 1.0;
e. Debt-to-equity ratio (leverage) of not more than 3:1 (75%); and
f. Current ratio of 1 or higher.

37. The operational covenants applicable under proposed investment project are:

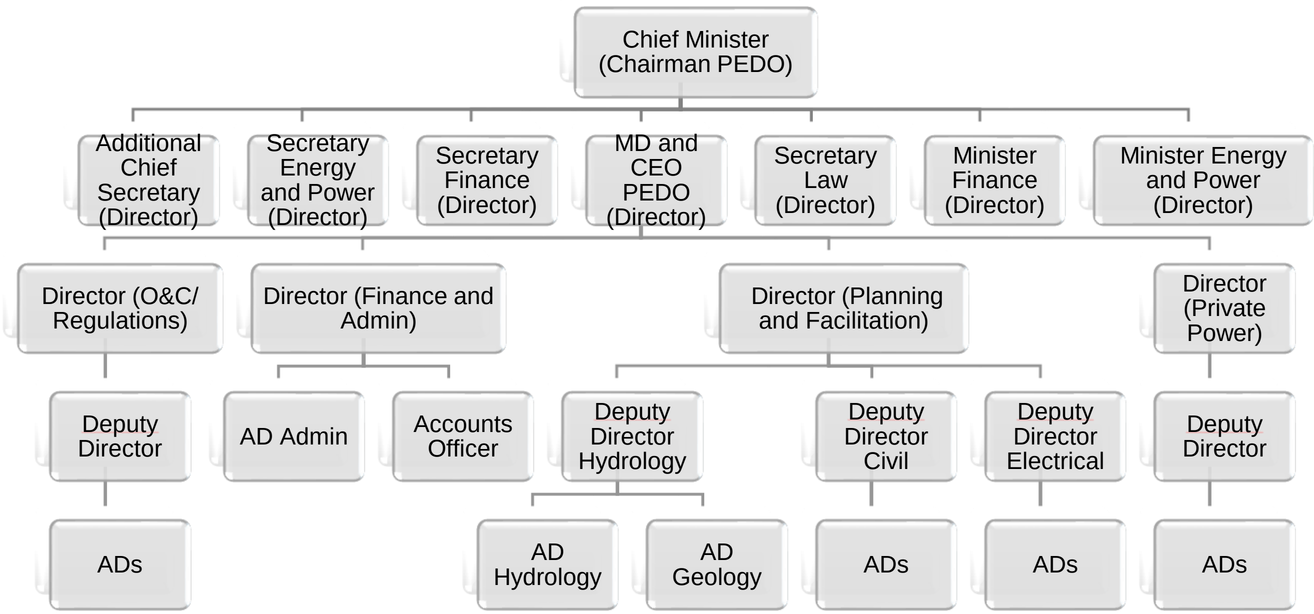
a. PEDO will submit to ADB investment plans as required under NEPRA Investment Standards and Procedures (Hydropower Generation) Rules, 2015, including, but not limited to, the periods of one year, up to three years and up to ten years, and historic data for the last five years and forecasts as to load growth for the next 5 years; and
b. PEDO will file tariff applications with the NEPRA seeking a tariff determination in accordance with NEPRA (Tariff Standards and Procedure) Rules as required to recover costs and maintain the regulated return on assets at all times.

I. CONCLUSION

38. PEDO’s financial management risk is *substantial* and financial management capabilities are weak. PEDO’s accounting policies, procedures, and financial reporting have followed federal accounting and auditing standards, however, the company does not prepare its accrual reporting compliant with IFRS. The company has insufficient capacity for timely preparation of accrual accounts, financial planning, and audit. It is noted that PEDO has not submitted audited entity’s statements for FY2017 and FY2018 till date and is expected to do so only by end 2019. Given its private sector development mandate, the company needs to prioritize the implementation of capacity development measures in the respect of qualified financial and accounting staff capacity development and retain, automation of accounts consolidation and management reporting process, and ability to maintain IFRS compliant reporting.

39. PEDO’s financial position is dependent on (i) equity contribution from the government and (ii) timely approval of its tariff petitions for newly built hydropower plants by NEPRA. The company’s management has approved commercialization and capacity building activities with provincial government’s commitment to strengthen PEDO’s corporate governance, management capacity, financial resilience, and sustainability. Among the most urgent measures, the KPK government prioritizes the empowering supervisory and management boards, implementation of ERP and capacity building measures. Loan covenants have been included to address this concern from ADB perspective.

Figure 1: PEDO's Corporate Structure



AD = Assistant Director, CEO = Chief Executive Officer, MD = Managing Director, PEDO = Pakhtunkhwa Energy Development Organization

Appendix 2

Table 2: PEDO's projected financial statements

INCOME STATEMENT (In Million PKR)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Revenue from Hydel Projects	2,408	2,771	3,226	4,137	4,915	5,003	5,218	5,378	5,546	5,730	5,901
Revenue from Balakot HPP	0	0	0	0	0	0	0	0	15,994	16,650	17,332
TOTAL REVENUE	**2,408**	**2,771**	**3,226**	**4,137**	**4,915**	**5,003**	**5,218**	**5,378**	**21,540**	**22,380**	**23,233**
Operational Cost	903	1,289	1,331	2,097	2,232	2,300	2,371	2,445	2,523	2,603	2,686
Operational Cost of Balakot HPP		0	0	0	0	0	0	0	3,960	4,123	4,292
EBITDA	**1,505**	**1,482**	**1,895**	**2,041**	**2,683**	**2,703**	**2,846**	**2,933**	**15,057**	**15,644**	**16,255**
Other Income	102	217	195	189	196	207	210	270	308	290	512
Depreciation	438	1,001	1,326	1,710	1,761	1,865	2,202	2,232	2,947	2,947	2,947
Depreciation of Balakot HPP									716	716	716
Interest Charges for Balakot HPP									2,467	2,372	2,276
Earning for the Period	**1,209**	**697**	**764**	**520**	**1,119**	**965**	**855**	**974**	**9,019**	**9,318**	**9,774**
CASH FLOW STATEMENT	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**
Cashflow from Operations	1,455	688	861	1,767	2,027	2,161	2,986	3,070	11,514	19,998	20,777
Cash flow from Financing	13,759	12,239	5,143	2,037	747	3,544	518	417	(12,273)	(13,005)	(14,037)
Cash flow from Investing	(14,106)	(13,121)	(6,317)	(3,636)	(2,381)	(5,309)	(2,617)	(2,454)	201	212	464
CASH GENERATED FOR THE YEAR	**1,108**	**(183)**	**(313)**	**168**	**393**	**397**	**916**	**1,033**	**(559)**	**7,208**	**7,204**
Cash Balance brought forward	2,562	3,669	3,485	3,172	3,910	4,304	4,640	5,535	6,589	6,001	13,206
NET CASH AVAILABLE	**3,669**	**3,485**	**3,172**	**3,340**	**4,304**	**4,640**	**5,556**	**6,589**	**6,001**	**13,208**	**20,470**
Debt Servicing									3,285	3,319	3,416
BALANCE SHEET	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**
Fixed Assets	50,541	63,800	67,943	69,960	70,727	74,271	74,819	75,236	151,686	145,323	138,860
Current Assets	4,951	5,605	6,429	6,981	8,115	9,110	9,966	10,940	17,992	25,044	32,097
TOTAL ASSETS	**55,493**	**69,404**	**74,372**	**76,943**	**78,842**	**83,382**	**84,785**	**86,176**	**169,678**	**170,367**	**170,957**
Non Current Liabilities	24	24	24	24	24	24	24	24	79,421	76,005	72,489
Current Liabilities	87	101	101	136	147	148	148	148	149	149	149
TOTAL LIABILITIES	**110**	**124**	**125**	**159**	**171**	**171**	**172**	**172**	**79,570**	**76,154**	**72,638**
Projects Equity	48,151	60,409	65,552	67,589	68,337	71,881	72,429	72,845	74,950	77,055	79,160
Retained Earnings	7,231	7,928	8,695	9,215	10,334	11,329	12,184	13,158	15,158	17,158	19,158
TOTAL EQUITY AND LIABILITIES	**55,493**	**69,404**	**74,372**	**76,943**	**78,842**	**83,382**	**84,785**	**86,176**	**169,678**	**170,367**	**170,957**
RATIO ANALYSIS	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**
Operating Profit Margin (%)	63%	53%	59%	49%	55%	55%	55%	55%	70%	70%	70%
Net Profit Margin (%)	52%	25%	24%	13%	23%	20%	16%	18%	40%	42%	42%
Fixed Asset Turnover (%)	5%	4%	5%	6%	7%	7%	7%	7%	14%	15%	17%
Return on net Fixed Asset (%)	2%	1%	1%	1%	2%	1%	1%	1%	10%	11%	12%
Operating Expense to Operating Revenue (%)	37%	47%	41%	51%	45%	45%	45%	45%	30%	30%	30%
Debt Services Coverage Ratio	-	-	-	-	-	-	-	-	2.65	2.75	2.86
Debt to equity	0.20%	0.18%	0.17%	0.21%	0.22%	0.21%	0.20%	0.20%	88.30%	80.82%	73.88%
Current ratio	57	56	64	52	55	62	67	74	121	168	215