Background Note: Multilateral Missteps in Pakistan's Energy Sector[1]

I. Lessons from the ADB's Energy Assistance to Pakistan: 1985 - 2006[2]

Cumulatively through end 2008, 21 percent of ADB lending to Pakistan—totaling $4.072 billion—went to the country's energy sector. Though the sector has always been a central focus, the Bank's strategy has gone through near-constant evolution. In the 1980s, the ADB focused on infrastructure; at the time, there was no mention of structural reforms or the private sector. By the mid 1990s, the ADB and the World Bank began supporting the Government of Pakistan's privatization efforts. By 1999-2001, the ADB's strategy had changed entirely to a focus on the sector's financial conditions. Policy reforms, sector restructuring, privatization and governance became the core focus. In 2006, the strategy shifts again to technical assistance for renewable energy, transmission, distribution, restructuring and privatization.

From 2000 to 2004, ADB financed a $203 million "Energy Sector Restructuring Program." The program focused on reforming Pakistan's energy sector— to introduce competition and private sector participation, enhance governance, and finance the privatization of corporatized entities. ADB's rationale for the program was that the roots of the energy crisis were weak governance, political interference in decision-making, poor staff morale, and disregard of prudent business practices. ADB asserted that weak governance resulted in inefficient utility operations, power theft, reduced billing and collection, and nonpayment of arrears. The ADB concluded that radical reforms and tough adjustment measures, including market-driven systems, were needed to restore viability in the sector and make it self-sustaining.

ADB's 2006 evaluation indicated that the program achieved "most of" the planned outcomes, and all components were "at least partially" achieved. Challenges identified include incomplete privatization, persistent capacity shortfalls, delays in the creation of a central power purchasing agency, failure of the Government of Pakistan to announce tariffs for power retailers, lack of clarity in subsidy policies for the sector, and hesitancy of the Pakistan Government to make difficult decisions, particularly on privatization. The loan was cancelled in 2004.

Reviewing its experience with Pakistan's energy sector, the ADB concluded that "the overall performance of the power sector and its institutions over the past 15 years has been ***at best moderate***."[3] "Sector unbundling, corporatization, and privatization have proceeded slowly. As

[1] Prepared by Molly Kinder (mkinder@cgdev.org), Senior Policy Analyst at the Center for Global Development, on May 10, 2010.
[2] *ADB Country Assistance Program Evaluation for Pakistan: May 2007.*
[3] Since the problems reported above in 1998, the ADB and World Bank have had some important achievements. These include: establishing a functioning regulatory agency, restructuring WADPA, privatizing Karachi's Electricity

in other client countries, *reform of the power sector has been disappointing* since the mid-1990s. Every covenant on debt servicing and counterpart funding has not been complied with. Investments in generation, transmission, and distribution got out of balance, with excess generation capacity in the late 1990s."

These failures persist *despite* the persistent and coordinated efforts by the lead donors (World Bank and ADB). There has been a "high level of consistency between the approaches of the two major development partners, as well as with the IMF in agreeing Pakistan's structural adjustment program. The ADB notes: "ADB and World Bank have been clear and consistent in their focus on these areas and government has stated support in principle in agreeing loan conditions and public statement." Despite all of this, the donors have had very little leverage. Again, the ADB: "The reforms, while complex, do not require such long periods to complete. *The means to reduce technical losses and improve financial performances are well understood. Hence, the outcomes must be viewed more as a failure of implementation of government policy than of ADB strategy*." The assessment finally declares, "It is clear that the commitment to reform and performance improvement of those working in the power sector has been neither complete nor consistent."

II. Lessons from the World Bank's privatization efforts in the 1990s

In the early 1990s, the World Bank tried an innovative approach to attract private investment in Pakistan's power sector. (*See here for the full case study*). WAPDA (Pakistan's water and power authority) agreed to be unbundled and eventually privatized, and massive (greater than $1 billion) private power projects were established. The first of these projects – a $1.62 billion power project – won an award for "Deal of the Decade." The privatization strategy was deemed the "best energy policy in the whole world" by the then US Secretary of Energy. The success was clear: Pakistan was able to attract significant amounts of private capital quickly and efficiently. (This was due in part to incentives: a bulk tariff ceiling was established, a "one stop shop" for investors, fiscal incentives, etc). By 1998, just four years later, the Government of Pakistan was threatening to terminate nearly a dozen independent private power projects and the program was in shambles.

What went wrong? First, the important structural and policy reforms that the World Bank had been advocating were simply not implemented in the timeframe agreed upon. WAPDA was slow to be privatized, and the regulatory system remained weak. Second, WAPDA was in dire straits financially due to some of the same problems facing Pakistan today: an unwillingness of the Government of Pakistan to increase electricity tariffs to consumers. Then, as well as now, WAPDA's cash flow problems created a circular debt cycle: WAPDA would fall short in cash receipts, and then fall into arrears with other public sector enterprises, and the cycle would repeat. Soon WAPDA was using coercive and heavy-handed tactics to harass the private power projects to renegotiate and reduce tariffs. The environment became highly politicized, eroding investor confidence and scaring off foreign investment.

Supply Company, and improving the indebtedness problem. The success rate of the ADB's energy projects has risen to a high 81%, compared to 50% in the 1990s.

Lessons identified by the World Bank from its privatization program in the 1990s:

(a) The failure of the Government of Pakistan to pursue needed policy reforms and structural changes undermined the program.
(b) The World Bank concluded in 2005 that: “there is a strong consensus that private investment is not a substitute for reform, and that significant private investment in generation should not take place in front of reforms which at a minimum address efficiency and tariff policies.”
(c) The Bank concluded that the scale of the programs was too big for Pakistan’s state of development and governance capacity. “The difficulties with the project can largely be attributed to its size. Unless Pakistan had developed a track record of GOP contractual performance and successful implementation of power projects in the power sector, the Government should have concentrated its efforts on modest-sized, and as a consequence, more easily financed projects.”

Attachment: Tariff Reform Efforts in Pakistan's Energy Sector by the Asian Development Bank and World Bank[4]

I. ADB's Concern for Tariff Reform

Note: earlier project documents are inaccessible, although they likely contained similar statements on the importance of tariff reform (see World Bank documents below).

Energy Sector Restructuring Program Report & Recommendation (2000)

- The sector's persistent operational inefficiencies, high cost of operations, and retail tariffs that do not cover the cost of operations, have eroded the operating margins, profitability, and cash flows. **These have resulted in the sector's weak self-financing, debt service, and liquidity capabilities and its corresponding noncompliance with financial health covenants with ADB.**

Power Distribution Enhancement Investment Program Report & Recommendation (2008)

- [Distribution companies] will submit petitions for tariff revision as required to maintain [their] financial viability. Following tariff determination by NEPRA, the Government will undertake to notify such tariff determination in a prompt manner. **Starting 2009, the Government will ensure that the tariff formulated for DISCOs are adequate to cover operating costs, maintenance, depreciation, and financing cost and to allow an acceptable return on the equity of DISCOs.**

Energy Efficiency Investment Program Report & Recommendation (2009)

- Lack of tariff increases and the resulting shortage of funds for investment, maintenance, and augmentation have compromised the financial viability of the power sector. **The Government is taking steps through the power sector circular debt resolution plan to establish financial sustainability. The plan principles are (i) policy debt resolution, (ii) technical and financial improvement of company performance, and (iii) timely implementation of a cost recovery tariff.** The implementation of the plan will align the incentives for conservation and energy efficiency. Considerable political commitment will be needed to carry out the reforms. Close monitoring and coordination with the Government and other partners will be vital.

II. The World Bank's Concern for Tariff Reform

Power Sector Dev't Program (1994) Staff Appraisal

- "As also indicated by a Tariff Study completed by WAPDA with the assistance of consultants financed by ADB in 1991, **there is still a need for further overall rationalization of the tariff structure.** Therefore, additional measures are expected to be introduced under ongoing agreements between GOP and ADB including: (a) a time-of-use tariff for WAPDA's industrial

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[4] Prepared by Wren Elhai (welhai@cgdev.org), Research and Communications Assistant at the Center for Global Development, on May 10, 2010.

consumers with maximum demand in excess of 40 kW; and (b) a gradual increase in the FAS on domestic consumption between 150 and 300 kWh per month. Furthermore. GOP and WAPDA have agreed during negotiations that, with effect from September 30. 1995. a metered energy charge component will be included in all flat tariffs charged for tubewells (para 7.2)."

- "… Meanwhile, **the Government indicated its commitment to continue its effort to gradually reduce the cross-subsidies, on the occasion of tariff increases to meet the internal cash generation (ICG) covenant, while moving closer to the economic cost of supply."**
- "The proposed project would consist of: (a) a restructurinq and privatization component involving the implementation of a Strategic Plan which would include inter alia: (i) the reorganization and corporatization of WAPDA into a holding company with decentralized power generation, transmission and distribution subsidiaries operating as discrete autonomous profit centers; (ii) the establishment of a National Electric Power Regulatory Authority (NEPRA) to set standards and regulate a largely privately operated power sector; (iii) **the adoption of a pricing policy which would provide the incentives needed to support the project's privatization objectives**;"

Ghazi Barotha Hydropower Project (Dec 1995)

- "Section 4.05. WAPDA shall, with respect to the profits payable to the Provinces on the bulk generation of hydroelectric power:
  (a) **from time to time, adjust its electricity tariff to ensure full recovery of such profits**; and
  (b) pay out as such profits only those amounts as shall have been collected for payment of such profits."

From project completion report (QAG Panel)

- "Monitoring of WAPDA's financial performance by the Bank was quite effective but **in March 1997 when the GOP suspended critically needed tariff increases, the Bank management did not act decisively**. An important question is whether the Bank should have anticipated the financial crisis that enveloped WAPDA in 1997. The surge in fuel costs, the 17% devaluation of the currency and the impact of power purchases from the Hub River project should have been anticipated. The Bank might have lessened the crisis if it had moved to a rate of return covenant at the outset rather than retaining the self-financing approach which proved ineffective when WAPDA's investment program was reduced by the IPP program. As WAPDA is now facing financial illiquidity, as of to-date, the handling of this crisis by the Bank and proposed financial support operation is necessary and timely..."
- "The project was set up and supervised to complement reforms in the PSDP project, which established the key elements for reform of WAPDA. Ghazi-Barotha did include two important reform conditions for WAPDA reform; completion of full corporatization of WAPDA and establishment of a separate transmission company by December 31, 1998. **Evidence of progress on these changes and attention to them by supervision missions was not apparent**, although the May 1997 aide-memoire urged WAPDA to take faster implementation action. **The Panel feels that supervision missions should have included staff with specialized skills in corporate restructuring. GOP might then have paid more attention to them..."**
- "A factor contributing to the current disarray in WAPDA's finances may have been the delay in revising private power policies. Under this loan, GOP had agreed to do this by December 31, 1996. **It would seem that the Bank did not pursue this target actively enough.** It did propose a freeze on GOP issue of letters of support for IPPs and discussed the new policies in December 1997. However, the target date for meeting the covenant was not revised."
- "The financing plan for the Project (including donor commitments to provide the foreign currency resources for the various contracts) was a key element of the overall funding

requirement. However, **it was also important to document the circumstances which would enable WAPDA to contribute its share of the costs** (i.e., tariff increases to offset increases in operating costs, measures to strengthen governance and improve efficiency, etc), **and the Government's commitment to undertake the policy and institutional actions that were essential for reversing the deterioration in WAPDA's performance.** The Project included an agreement by WAPDA to finance about 40% of the cost of GBHP from its own resources—a commitment of US$1 billion equivalent, over 6-7 years. While the financial analysis carried out at appraisal highlighted the conditions under which WAPDA could generate this large surplus, the political and social implications of the substantial increase in tariffs (which were implicit in those projections) were not fully analyzed. Consequently, when the actual tariff increases were lower, WAPDA was not able to generate its share of the finances, and implementation of the Project suffered."

Structural Adjustment Loan (January 1999)

- Over the medium-term, the reform agenda would focus on: (1) completing the corporatization process and establishing commercially-oriented autonomous corporations, with NEPRA issuing licenses for the new corporatized entities; (2) implementing theft and loss reduction programs and introducing other efficiency improvements; (3) intensifying bill collection efforts from both public and private customers; (4) implementing financial and other restructuring measures; and (5) accelerating the privatization program for the thermal generation and electricity distribution companies.
- B) the Borrower has carried out the measures and taken the actions described in Schedule 3 to this Agreement to the satisfaction of the Bank:
    - 7. WAPDA has prepared a theft, loss and arrears reduction plan satisfactory to the Bank.
    - 8. The Borrower's federal and provincial governments have cleared their past bills with WAPDA and given an understanding satisfactory to the Bank to stay current on their future reconciled electricity bills as they become due.
    - 9. The Borrower's **Ministry of Water and Power has issued a statement on the government's socio - and economic - policy objectives regarding tariff setting to NEPRA.**
    - **10. NEPRA has issued under the NEPRA Act its Tariff Standards and Procedures Rules, and other terms and conditions related to generation, transmission and distribution by licensees.**
    - **11. WAPDA has submitted a comprehensive tariff filing to NEPRA satisfactory to the Bank.**

Structural Adjustment Credit (June 2001)

- "**The Borrower has notified the revised electricity tariff for energy sold by its Water and Power Development Authority (WAPDA), as approved by its National Electric Power Regulatory Authority (NEPRA)** during the quarter ending March 31, 2001. …"
- "The Borrower has adopted and communicated to NEPRA new policy guidelines for setting electricity tariffs, which: (a) allow for differential tariffs for the Karachi Electric Supply Company (KESC) and for the electricity distribution companies forming part of WAPDA; (b) **provide for reduction of cross-subsidies between consumer categories except for lifeline rates**; and (c) allow for formula-based multi-year tariffs."

Second Structural Adjustment Credit (June 2002)

- Power Sector Reform (Unsatisfactory). **The program achieved a number of positive steps, but the core problem was not remedied**. … **The major issues of dealing with WAPDA's existing debt and the poor collections rates (particularly from public sector consumers) are unremedied.** The planned debt-service coverage ratios (e.g., of 1.2 by 2002/03 and 1.5 by 2003/04) will not be achieved in the foreseeable future. Despite the progress toward corporatization, **the fundamental problem of WAPDA's financial unviability remains as serious as it was prior to SAC2.** WAPDA's operating losses continue at 25 percent of total costs. The annual cost to the Treasury is Rs.25-30 billion which is equal to WAPDA's debt service costs, or about 0.6 percent of GDP. The corporatized entities are not functioning autonomously as planned by December 2002 and are unlikely to do so until the end of calendar year 2003. **The electricity price increase issued by NEPRA (Fuel Adjustment Surcharge) was scaled back by about 20 percent (49 to 38 paisas/kwh) by the Government which has undermined NEPRA's role as a regulator of electricity prices**.

PRSC II Program Document (April 2007)

While the increased losses of the Water and Power Development Authority (WAPDA), due to higher fuel prices and stagnant electricity tariffs, are likely to increase the quasi-fiscal deficit, the Government announced a tariff increase in February 2007, which will reduce power sector losses, and has taken some significant steps to improve the management o f the sector.

100. The Government on February 24, 2007 notified tariffs for WAPDA-successor distribution companies (Discos), which was a PRSC II prior action. This notification is an important first step in establishing the distribution companies as financially autonomous entities, as opposed to being financially managed as a vertically integrated utility, as it legally enables the companies to retain the revenues collected by them. This is the first time that consumer tariffs determined by the National Electric Power Regulatory Authority (NEPRA) are regionally differentiated. The new NEPRA-determined tariffs, which have been posted on NEPRA's website, are higher on average (averaging across Discos and across consumer categories) by about 28%; the average increase for varies from 6.5% for the Gujranwala distribution company (GEPCO) t o 67% for the Hyderabad distribution company (HESCO). **The Government however, has decided not to pass the full tariff increase to consumers and will maintain uniform electricity tariffs across the service areas of all Discos.** Notified tariffs are approximately 6.5% higher on average relative to the previous tariffs. The difference between notified tariffs and those determined by NEPRA is to be covered by the Government budget. **While the increase in regulatory tariffs reduces the need for budget support to the sector by almost one fourth relative to the pre-tariff notification period, the financial gap in the sector will remain significant, and is projected to be in the range of Rs.60 billion f or 2006/07.**

Electricity Distribution and Transmission Project Appraisal (May 2008)
Covenants applicable to project implementation:

End Consumer Tariffs: Until such time that the adjustment for power purchase price (PPP) is automatically passed through to the end consumer tariff, HESCO, IESCO, LESCO and MEPCO to file tariff applications and/or tariff petitions to NEPRA, in accordance with the provisions o f the NEPRA Act.

Timely Tariff Notification: Government of Pakistan to notify NEPRA determined tariffs, or file a request for review, no later than 15 working days following such NEPRA determination, as per NEPRA Act. In case that review is requested, the Government will notify NEPRA determination within a reasonable time period after NEPRA's completion of the requested review, to ensure its timely implementation.

Timely Payment of Subsidies: Ministry of Finance to transfer invoiced subsidies submitted by DISCOS for energy billed as well as any other monies due on a monthly basis and not later than the 25th o f each month in accordance with approved "Standard Operating Procedure (SOP) with Timelines and Responsibilities for Sale and Purchase of Electricity".

GOP reviewing options to (i)decrease the differential between determined and notified tariffs to reduce the subsidy obligation and (ii)introduce more frequent tariff adjustments (e.g. monthly, quarterly); Fiscal obligations to be reduced over time;