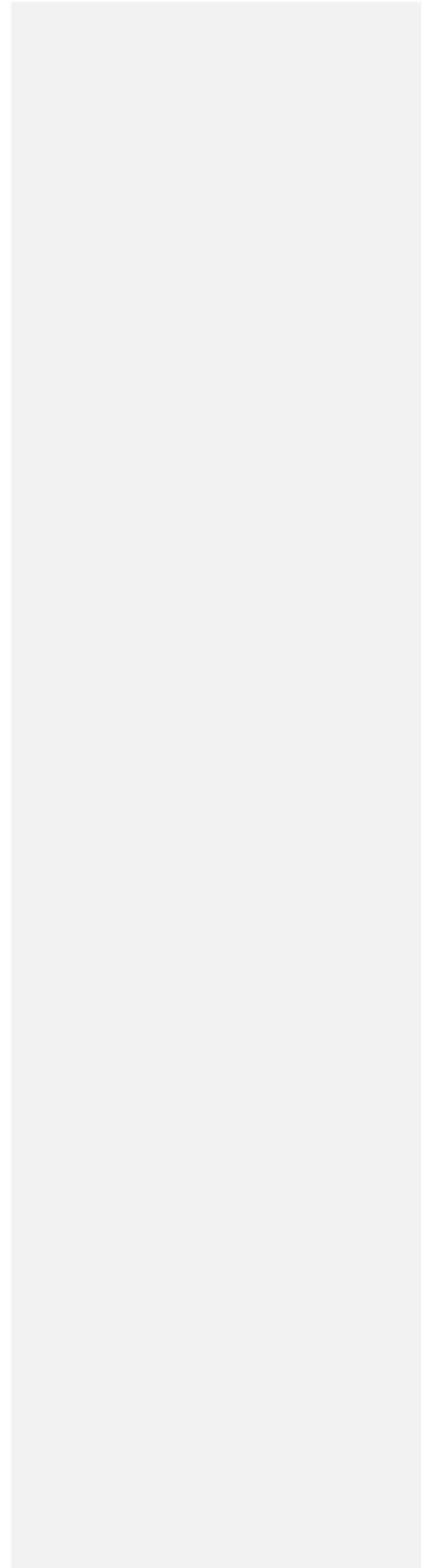


The History of Private Power in Pakistan

Fahd Ali and Fatima Beg

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Abbreviations

| | |
|-------|--|
| ADB | Asian Development Bank |
| C.C | Combined Cycle |
| FERI | Foreign Exchange Risk Insurance |
| FY | Financial Year |
| GOP | The Government of Pakistan |
| HUBCO | Hub Power Company |
| IFC | International Finance Corporation, Member of the World Bank Group |
| IPP | Independent Power Producer |
| KAPCO | Kot Addu Power Company |
| KESC | Karachi Electric Supply Corporation |
| LTCF | Long Term Credit Fund |
| MIGA | Multilateral Investment Guarantee Agency, Member of the World Bank Group |
| MWP | Ministry of Water and Power |
| NDFC | National Development Finance Corporation |
| NEPRA | National Electric Power Regulatory Authority |
| PPA | Power Purchase Agreement |
| PED | Private Energy Division |
| PPC | Private Power Cell |
| PPIB | Private Power and Infrastructure Board |
| PSEDP | Private Sector Energy Development Programme |
| PSO | Pakistan State Oil |
| WAPDA | Water Resources and Power Development Authority |
| WB | World Bank |
| WPPO | WAPDA Private Power Organisation |

The History of Private Power in Pakistan

Fahd Ali and Fatima Beg

1 Abstract

The 1994 power policy was highly successful in that it attracted substantial foreign direct investment to Pakistan's power sector. However, the policy also generated a great deal of controversy in which the independent power producers were accused of using illegal means to secure lucrative contracts. This paper attempts to present the controversies and issues that surrounded the policy. We conclude that like most policy-making processes in Pakistan, the power policies are designed with little or no input from relevant stakeholders. We suggest that the way forward lies in strengthening electricity regulation in the country, empowering civil society, and restructuring WAPDA, but not necessarily privatizing it in the process.

1.2 Introduction

Established in 1986, the Hub Power Company (HUBCO) was the largest private sector power generation venture in Asia. HUBCO and the rest of Pakistan's independent power producers (IPPs)—all of them thermal plants—now account for 30 percent of total electricity generated (Government of Pakistan [GoP], 2006). However, this share enjoyed by the IPPs does not exist without a price. Since the advent of the IPPs in the country in 1994, the electricity tariffs have been rising constantly. The liberalization of the power generation sector has drained the Water and Power Development Authority's (WAPDA) resources - it is running into huge losses. According to one estimate, the utility is currently running into a loss of several billion rupees. One could always argue that the IPPs have not done this alone. WAPDA has been in poor shape for years and needs a massive overhaul to turn its fortune around. True, however, the IPPs alone cost WAPDA one billion dollars in capacity payments every year. Hypothetically speaking, this means that if all of the IPPs in Pakistan do not produce a single unit of electricity, WAPDA would still have to pay them for the availability of their capacity.

The advent of newspaper discussions on IPPs has raised various issues such as privatization, tariff rates, the GoP's policies, the power sector's restructuring, the utilization of local fuels, the efficiency of the organizations concerned, and the involvement of multilateral agencies. These discussions have been fuelled by the effects of allowing IPPs to operate in Pakistan, the most visible of which is a 100 percent increase in electricity tariffs in rupee terms since 1994. One therefore finds it appropriate to analyze the effects of opening up the power generation sector to private investors.

This paper analyzes the 1994 policy to determine what problems occurred after its implementation, what the resulting losses were, and who is responsible for them. It also suggests a future course of action that may be adopted to meet the power shortage. Although the report still leaves many questions unanswered, the effort here has been to summarize and compile

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existing information. Much more information is required to give a qualified judgment, and the Government has, unfortunately, been very reluctant to share information. The tariff formula/methodology used to determine the bulk tariff rate for IPPs in the 1994 Power Policy is not available for public scrutiny. In addition, WAPDA has been unwilling to share its data - which is generally considered public. Public access to these statistics was restricted by an “executive” order as they contained “sensitive” information.

The dearth of information in the power sector has prevented us from calculating the costs that IPPs have transferred to the public. These include the high bulk power tariff paid to the IPPs by WAPDA, and the savings made by IPPs through fiscal incentives.

23 Pakistani private power generation

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2-13.1 *The initial plans for private power*

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WAPDA and the Karachi Electric Supply Corporation (KESC) owned all power generating plants in Pakistan up until the mid 1980s. In 1985, a lack of funds in the public sector forced the Government to discontinue its support to WAPDA. However, since the country’s energy demands were continuing to grow, it developed a long-term energy strategy—with World Bank support—that encouraged private companies to invest (Fraser, 2005).

The Private Sector Energy Development Programme (PSEDP) consisted of several projects. PSEDP 1 and PSEDP 2 were set up by the Government and the World Bank to develop the private power generation sector. Several governments and international donor agencies supplied loans to build a fund. PSEDP 1, which was approved in 1988, established the Private Sector Energy Development Fund (PSEDF). PSEDP 2 commenced in 1994 and replenished the PSEDF to attract further private investment, and work with the new institutional developments. PSEDF 2 was then called the Long-term credit fund (LTCF) and was controlled by the National Development Finance Corporation (NDFC). However, now, after its merger with the National Bank of Pakistan (NBP), the LTCF is controlled by the NBP¹.

The combined funding of PSEDF 1 and 2 amounted to almost USD 1.5 billion, of which the World Bank provided USD 400 million. The PSEDFs provided up to 40 percent of the capital cost at an interest rate of 14 percent. Relatively few IPPs secured loans (which were subordinated to commercial loans) from them. PSEDF 1 only financed HUBCO, the first private power plant in Pakistan. HUBCO’s capital cost totaled USD 1.766 billion of which PSEDF 1 financed about 30 percent (HUBCO, 2006). PSEDF 2 financed three IPPs of the 1994 policy (World Bank, 2001).

¹ Chaudhry, 2002.

2-23.2 The HUB Power Company

A consortium led by Xenel Industries of Saudi Arabia (later National Power of UK) built HUBCO, locating it near the Hub River in Balochistan. Although the feasibility study was completed in 1988 (HUBCO, 2006), the project met repeated delays because of the Gulf War, the withdrawal of contractors, frequent changes in government, and the declaration of interest on loans being illegal (World Bank, 2001). Financial close was achieved in January 1995 which made the project much more expensive than originally planned. The costs had risen from about USD \$1.2 billion to USD 1.766 billion. This meant that the unit price that WAPDA had to pay HUBCO for electricity had to be renegotiated as well; they had increased to 250 paisas per Kilowatt-hour (paisas/KWh), then equivalent to six US cents. This rate was calculated by promising a rate of return of 18 percent. HUBCO was finally commissioned (i.e. it started selling electricity) in 1997.

2-33.3 The other companies

2-3-13.3.1

1994 power generation policy

Load shedding increased in the country while the HUBCO project was still in the works. The Government expected a power shortage of about 2,000 MW in the coming years (GoP, 1994a). Knowing it would be impossible to finance such large public projects, it constituted an energy task force in 1993 that was mandated to carry out a study of Pakistan's electricity demands up to the year 2020 (Shah, 2002). The Task Force published a report called "Report of the Prime Minister's task force on energy". The Government's 1994 private power policy—which is called "Policy framework and package of incentives for private sector power generation projects in Pakistan"—is based on its results. The policy adopted most of the Task Force report's features, especially the tariff and the fiscal incentives.

The 1994 Power Policy was designed to attract foreign investment in Pakistan. The Government offered very generous and lucrative incentives to investors as this was the first time it was actively seeking substantial private investment in the power sector. The policy used a "cost-plus" method² to determine electricity tariffs and offered an attractive tariff of 6.5 cents/KWh to prospective investors.

Besides a high tariff rate, the IPPs were allowed to use any technology apart from large hydro projects on the Indus. They were also free to choose any main fuel. Today, all IPPs are thermal power plants based on furnace oil, high-speed diesel (HSD) oil, or natural gas.

² For the "cost-plus" method the cost per unit of production (i.e. per KWh) is calculated. Then a certain profit per KWh is added. This is done to ensure profits and thereby attract investors to engage in a risky business. The most common criticism of this method is that it does not give investors an incentive to decrease costs.

The founding of a new institution called the Private Power and Infrastructure Board (PPIB) accompanied the policy’s implementation.³ The 1994 policy offered several concessions, including many fiscal incentives (GoP, 1994a p. 5–7):

- Low taxes, duties, and fees;
- Foreign Exchange Risk Insurance (FERI)⁴ by the State Bank of Pakistan and the freedom to choose insurance companies (GoP, 1994a p. 5–7);
- Security packages (which are standardized agreements like the Power Purchase Agreement [PPA] and the Fuel Supply Agreement) to spare WAPDA, KESC, and the IPPs from prolonged negotiations. These also include guarantees given by the Government for the continued performance of WAPDA, KESC, and public sector fuel suppliers (GoP, 1994a p.7).

The policy’s most important feature was its “bulk power tariff”, which was calculated assuming a 60 percent capacity factor. The tariff consists of two components:

1. **The capacity payment** has to be paid by WAPDA every month, whether or not it actually receives any electricity from the IPP that month. It includes the fixed costs—operations and maintenance, insurances, administrative, and debt servicing—and the return on equity.
2. **The energy payment** depends on the amount of electricity purchased. It accounts for the variable costs, namely the usage of fuel, variable operations, and maintenance costs.

A tariff per KWh was calculated according to set assumptions for these payments. The average for the first ten years was not allowed to exceed US cents 6.5/KWh (then PKR 1.952/KWh). The rate was later revised to US cents 6.1/KWh (the FERI payment was subtracted). The levelized tariff over the lifetime of the power plant was to be US cents 5.91/KWh at the most. Tariff adjustments can be made when necessary, for example, to changing fuel prices. The tariff is structured according to debt servicing - it falls as debt servicing decreases. These very rates were offered to every IPP irrespective of technology or fuel used. The tariff could of course be lowered if an IPP showed that its costs were less than assumed in the policy.

Table 1 below shows the original bulk tariff rate as calculated in the 1994 Power Policy.

Table 1: Tariff rate in the 1994 Power Policy

| Energy price | PKR/KWh |
|--|---------|
| Fuel | 0.621 |
| Variable operation & maintenance | 0.030 |
| Capacity price | |
| Escalable component (fixed operations & maintenance, insurance, administration, return on equity etc.) | 0.359 |
| Non-escalable component (debt servicing) | 0.822 |
| Foreign Exchange Risk Insurance | 0.120 |

³ See Appendix 1 for the institutional framework.

⁴ The FERI is payable to the State Bank of Pakistan to be protected against changes in the foreign exchange rate. This is important because the investor usually has to repay foreign debt (GoP, 1994a annexure 1, p. 3). The GoP decided to include this component to be able to attract foreign investors.

| | |
|---------------------|-------------------------------|
| Total tariff | 1.952 (= US cents 6.5/KWh) |
|---------------------|-------------------------------|

Source: GoP, 1994a, annexure 1 and GoP, 1994b, schedule 6, p. 9

2.3.23.2

IPPs

The

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Many foreign, as well as domestic investors decided to build power plants in response to the 1994 Power Policy. The foreign investors included European, Arabic, US, and Japanese firms, international bank consortia, and several multilateral lending agencies like the Asian Development Bank (ADB) and the World Bank. As the 1994 Power Policy offered a tariff and concessions that were attractive, local and foreign investors handed in many more applications than previously expected. The GoP issued letters of support to projects for more than 9,000 MW (World Bank, 2001, p. 8). In the end, 19 companies that collectively accounted for approximately 3,500 MW (PPIB, 2003) achieved financial close. An excess of 1,500 MW was allowed, so as to meet financial close when the immediate requirement was only 2,000 MW. As it turned out, four (about 500 MW) of the 19 companies were not commissioned. The excess capacity was therefore 1,000 MW. Together with the fact that the power demand did not increase as much as expected, Pakistan suddenly had a big surplus of power.

The 1994 Power Policy attracted over USD 3 billion of investment, not counting the HUBCO project and the privatization of the Kot Addu Power Company (KAPCO). The complete investments in private power between 1990 and 1999 totaled USD 5 billion. (World Bank, 2001, p. 5) Different organizations of the World Bank Group have been involved with 12 IPPs, one of them being HUBCO. Providing loans or guarantees, their involvement added up to 86 percent of the IPPs' power capacity, and in terms of funding, up to about 20 percent of the total cost (Leeuwen, 1999).

At the moment there are 21 independent power generation projects: HUBCO, KAPCO, and 19 that come under the 1994 policy⁵. Planned private power generation capacity today makes up around 5,800 MW, almost a third of total capacity. HUBCO and KAPCO are the biggest plants, with a combined capacity of 1,800 MW. The commissioning began in 1997, but five plants which can ostensibly provide a further 440 MW remain un-commissioned. The Government developed several power policies in the following years, but none of them were particularly successful in attracting foreign investment in the power sector.

3.4 The discussions after 1994

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Criticism against the private power sector and the institutions involved started off when the IPPs were charged with corruption by the Nawaz Sharif government, and when consumer tariffs kept on increasing. These issues were widely publicized in the press, as various stakeholders began accusing each other of corruption and bad intentions. Section 3 goes on to analyze all relevant charges.

⁵ See Appendix 2 for listing of IPPs. It differs from the table in the next section because it has a different source.

3-14.1 Problems on the public sector front

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3-1.14.1.1

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policy

Many have argued that the bulk tariff rate of 6.5 cents/KWh (after dropping the FERI 6.1 cents/KWh) was too high. It did not give the IPPs any incentive to control costs, and WAPDA ended up paying this ceiling price most of the time. However, the bulk tariff did not seem exaggerated at that time because it was comparable to what was being paid in other Asian countries. It is difficult to say whether the components of the tariff were justifiable or not because their calculations are confidential. However, an element of the capacity purchase price attracts one’s attention. The escalable component includes the fixed operations and maintenance costs, the insurance costs, the administrative costs, and the return on equity. The size of the escalable component is determined at financial close, and rises according to a predetermined indexation (GoP, 1994a). Consequently, the profit of the IPPs, i.e. the return on equity, is guaranteed to be paid, and yet also guaranteed to rise in the framework of the policy. Simply put, this means that investors carry no business risk because they have been guaranteed a certain return on their investment anyway. This exercise promotes cost inefficiencies on the IPP side. Table 2 gives the magnitude of capacity charges WAPDA had to pay to the IPPs for the financial year 2001–02.

Table 2: IPP power production and tariff rates

| Name of Power Producer | Capacity (MW) | Capacity charges: escalable (PKR Million) | Revised capacity charges (PKR Million) | Total capacity charges (PKR Million) |
|------------------------|---------------|---|--|--------------------------------------|
| Liberty (C.C)* | 210 | 493 | 1,142 | 1,635 |
| Habibullah | 126 | 682 | 952 | 1,634 |
| Fauji | 150 | 452 | 1,307 | 1,759 |
| Uch (C.C) | 548 | 3,055 | 3,476 | 6,531 |
| Kapco | 1,265 | 7,700 | 4,116 | 11,816 |
| Rousch | 355 | 1,979 | 2,211 | 4,191 |
| Hubco | 1,200 | 5,392 | 7,985 | 13,377 |
| KEL | 120 | 467 | 1,087 | 1,554 |
| SEPCO | 112 | 426 | 910 | 1,336 |
| Japan | 107 | 410 | 441 | 851 |
| Saba | 123 | 523 | 811 | 1,335 |
| AES Lalpir | 351 | 1,653 | 2,402 | 4,055 |
| AES Pak Gen | 344 | 1,618 | 2,703 | 4,321 |
| Altern | 10 | 55 | 46 | 100 |
| CHASHNUPP | 300 | - | 3,356 | 3,356 |
| Total | 5,321 | 24,905 | 31,993 | 57,851 |

Source: NEPRA, 2002

Note: * Combined cycle

The payments shown in table 2 are obligatory; such was the nature of the PPA signed between WAPDA and the IPPs.

That the tariff was to be paid in US dollars rather than in rupees was another burden on WAPDA because the steady devaluation of the rupee over the years meant WAPDA had to pay more in real terms. The US dollar was worth about PKR 30 when the policy was implemented. . Today, the dollar fluctuates around the 60-rupee mark.

Many of the tariff hikes are due to increases in the price of furnace oil. The policy had assumed a rate of PKR 2,843/tonne; the price has increased four times since then. These price changes depend on:

- The international price;
- The taxes and duties imposed by the Government;
- Rupee devaluation against the US dollar;
- Pakistan State Oil's (PSO) monopoly. For example, PSO bought fuel oil at USD 66/tonne and sold it at USD 140 to the IPPs (Malik, 1998).

The guaranteed capacity payment⁶ was another heavily criticized element of the tariff. It forced WAPDA to pay for power capacity it was not actually buying. If the IPPs produced at a load factor of 60 percent or higher, the capacity payment was no burden on WAPDA. But at a load factor smaller than that (which was true in several cases) WAPDA's costs per unit rose.

The consequences were very high costs for WAPDA. The obvious solution was to raise the consumer tariff or risk incurring financial losses. The better solution however, would have been to:

- Minimize power loss and theft;
- Improve billing;
- Restructure tariffs;
- Maintain transmission lines;
- Ensure reliable power supplies so that more industrial consumers would choose WAPDA over private plants.

Another issue often raised in debate is that the incentives offered to the IPPs were too generous. It was clear from the beginning that these incentives meant huge cost savings for the IPPs and a massive burden on the public exchequer. However, the Government had obviously not expected very much foreign investment, and subsequently thought the incentives necessary.

⁶ The "guaranteed capacity payment" is also called "take or pay principle." It simply refers to an agreement where the buyer still pays a certain amount to the seller even if the good or service is not actually bought. For further details see <http://financial-dictionary.thefreedictionary.com/Take+or+Pay> and http://www.investorwords.com/4867/take_or_pay_contract.html

The growth expectations of power demand had not been anticipated either. The Energy Task Force's report had been overly optimistic about the growth in electricity demand, and had not expected the economy to perform as poorly as it did. Furthermore, it could not predict that many industrial consumers would stop relying on WAPDA's unstable power supply. Industries require an uninterrupted supply of power because they can incur huge losses due to just a few minutes of load shedding.

3.1.24.1.2

implementation

Policy

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The huge power surplus that Pakistan experienced is due not only to the exaggerated demand forecasts, but also to the policy itself. Having seen that the number of interested investors was much higher than expected, or for that matter, required, the Government should have stipulated that it was not willing to accept more than 2,000 MW of power generation capacity, and that IPPs achieving financial close *after* this number had been reached, would not be supported. Secondly, the Government should have lowered the bulk power tariff when the number of investor applications exceeded the country's requirement. Instead, the tariff remained static, (the annual revisions planned never materialized) and the Government accepted too many IPPs (World Bank, 2001).

Capacity rose to an excess of 1,500 MW over and above the intended amount. Every project accepted was incorporated into the 1994 rules and regulations; many of them well after 1994. This act left the Government and its departments open to allegations of corruption. However, there is no clear proof of this.

The 1994 Power Policy called for major changes in the power sector structure, including the foundation of the PPIB, the NDFC, and NEPRA.⁷ However, political interference was rampant, making it difficult for these institutions to work independently and utilize their own expertise; managerial level employees were changed according to each government's preference (World Bank, 2001).

Kamal (2002) proposed some potential solutions to the problems of high consumer tariffs and the power surplus:

- WAPDA could have shut down its own plants for a certain period of time to reduce the surplus and its costs;
- It could have lowered tariffs and worked on providing a more reliable power supply to increase demand and prevent further reduction of industrial demand.

There had been talk of ideas like selling the surplus to India, and restructuring the tariff system to encourage consumption, but nothing concrete came about.

⁷ See Appendix 1 for an overview of the history and functions of different organizations involved with power generation.

Table 3: Politicians connected to IPPs

| | | |
|--------------------------|---|--|
| Power Generation Systems | Yousaf Raza Gilani | Former Speaker of the National Assembly, Member of Pakistan Peoples Party (PPP) |
| Wak Power | Senator Gulzar | |
| Security Electric | Javed Saifullah Khan | |
| AES | Shahid Hassan Khan | Chairman of Energy Task Force set up by former Prime Minister Benazir Bhutto, during her second tenure |
| Uch Power | Farooq Hassan and Salman Farooqi | Salman Farooqi was a high level Government official during PPP's second tenure from 1993–1996 |
| Davis Energen | Ummekalsum Imam, Abida Hussain and Shahid Khaqan Abbasi | Abida Hussain was then a member of the Pakistan Muslim League (Nawaz) [PML-N] |
| Northern Electric | Naseem Sarfaraz and Sardar Asif Ahmed Ali | Sardar Asif Ahmed Ali served as Foreign Minister during PPP's second tenure |
| Berty Power | Asif Ali Zardari | Former Prime Minister Benazir Bhutto's spouse |

Source: Saleem, 1998

The IPPs were brought into the fold in a very non-transparent manner. The names of those involved in IPPs (shown in table 3) imply that political influence was being used to introduce IPPs into the country.

3.24.2 Problems on the World Bank front

Declaring itself one of the Government's main advisors in power policy matters (World Bank, 2001), the World Bank is also partly responsible for the IPP debacle. For example, it should have strongly advised the Government to lower the offered tariff as soon as it became clear that too many IPPs were being accepted.

The World Bank also admits to some of these errors. It criticizes its own preparation of PSEDP 1 and 2 (World Bank, 2001) and states that the long-term credit fund (LTFC) and its future were not given adequate thought. It goes on to say that the Bank should have ensured the NDFC was able to manage this fund (Dawn, 2001). The Bank's Implementation Completion Report (2001) states:

“Insufficient attention was devoted during appraisal of PSEDP 2 to the affordability of private power in Pakistan”.

The World Bank also states that it advised the Government to offer concessions that were excessive, like the tariff rate that included a return on equity of 25 percent after tax (World Bank, 2001 p. 18–19).

These mistakes are especially severe in light of the fact that the World Bank invested in only about 20 percent of IPP capacity, but was actually involved in 88 percent. This was possible because several different World Bank organizations were connected to the IPPs in different ways: The International Bank of Reconstruction and Development (IBRD) gave risk guarantees to HUBCO for USD 137 million and Uch Power Ltd. for USD 75 million, respectively. The Multilateral Investment Guarantee Agency (MIGA) provided guarantees for three projects for a total of USD 31 million. The International Finance Corporation (IFC) provided different kinds of loans to five different projects that amounted to about USD 378 million. Furthermore, the Government extended subordinated loans totaling USD 210 million from the LTCF to four projects (Fraser, 2005).

The Nawaz Sharif government accused the World Bank manager on energy projects in South Asia, Ibrahim Elwan, together with Asif Ali Zardari of corruption and appropriation of funds. They are suspected to have benefited personally from large power deals that they facilitated. As mentioned earlier, there is no real proof of these charges, only indications. An example of this is HUBCO, where Elwan's personal financial situation improved drastically after having negotiated the HUBCO deals (Arora, 1998).

3.34.3 Problems on the IPP front

The IPPs were accused of charging excessive tariffs. They stuck to the agreements they signed and calculated tariffs according to their costs as per the bulk power tariff scheme. Whether or not they quoted correct costs and undertook sufficient measures to reduce them *knowing* their profits were guaranteed, cannot be verified. As mentioned earlier, the Government should have stipulated restrictions in the policy to prevent rent-seeking behavior.

In 1997, the Government officially charged some IPPs (particularly HUBCO) of forcing it [the Government] into signing deceitful and unaffordable contracts. Although nothing really came of these legal proceedings, Pakistan's credibility suffered heavily and new foreign investment has subsequently become less likely. One very important emergent lesson is that the Government should clarify and strengthen conflict resolution mechanisms in such contracts. Firstly, the governing law of the agreements was the English Law, yet all cases were decided according to Pakistani law. Secondly, the contracts mentioned very clearly that the IPPs were free to seek international arbitration, but this commitment was never upheld by the State. WAPDA filed a suit against HUBCO and others in January 1999 in a senior civil judge's court in Lahore, asking the court, among other things, to restrain HUBCO from seeking international arbitration to resolve the dispute. The court decided in favor of WAPDA, and passed an *ex parte* order⁸, restraining HUBCO from seeking international arbitration (Kabraji, 2001). A Sindh high court judgment in March 1999 overturned the decision, only to be overturned itself by a later Supreme Court judgment that upheld the initial senior civil court's (Lahore) order restraining HUBCO

⁸ "A judicial proceeding, or, injunction, etc., is said to be *ex parte* when it is taken or granted at the instance and for the benefit of one part only, and without notice to, or contestation by, any person adversely interested." (Black's Law Dictionary - Abridged Sixth Edition [Centennial Edition, 1891-1991] p. 399.). See also, www.pakistanlawsite.com for definitions and examples of such orders/proceedings.

from invoking the international arbitration clause to resolve its tariff dispute with WAPDA⁹. The Supreme Court in its majority judgment noted¹⁰:

“The allegations of corruption in support of which the above mentioned circumstances do provide prima facie basis for further probe into matter judicially and, if proved, would render these documents as void, therefore, we are of the considered view that according to the public policy such matters, which require finding about alleged criminality, are not referable to Arbitration.”

The judgment further noted¹¹:

“The disputes between the parties are not commercial dispute arising from an undisputed legally valid contract, or relatable to such a contract, for, according to the case of WAPDA on account of these criminal acts disputed documents did not bring into existence any legally binding contract between the parties, therefore, the dispute primarily relates to very existence of a valid contract and not a dispute under such a contract.”

In effect, the majority judgment states that the dispute is not a commercial one, and cannot be referred for arbitration because the matter pertains to public policy and requires further probing of the allegation of criminality. Interestingly enough, the minority judgment held a completely opposite view. It considered that the law of arbitration of an agreement is separate from the main contract between the parties. The minority judges held that according to the arbitration clauses in English and Pakistani law, contracts are considered “separate and self-contained”¹² under the doctrine of “separability”. The minority judgment noted¹³:

“We are, therefore, clear in our mind that as held in the case of Hitachi Limited (supra) that while law of an arbitration agreement usually follows to proper law¹⁴ of the main contract, an arbitration agreement is separable from the main contract between the parties and arbitration agreement may have a different law which is provided within the arbitration agreement. In the instant case, the English Law has been provided in the arbitration agreement itself. Again the validity, effect, and interpretation of an agreement to arbitrate are matters of substantive law, governed by the proper law of agreement and not as matter of procedure to be determined by the lex fori of the Court called upon to enforce the trial. Since the parties in the instant case could and did choose the law which is

⁹ For details, see Supreme Court of Pakistan Judgement in Civil Appeals Nos. 1398 and 1399 of 1999, decided on June 14, 2000. See also, Pakistan Law Digest (PLD), Supreme Court 841

¹⁰ Ibid. See also, Kantor, 2001, p. 1,157.

¹¹ Ibid.

¹² Ibid at paragraph 31

¹³ Ibid at paragraph 43

¹⁴ ‘Proper Law’ is the governing law of an agreement. The governing law determines the rights and obligations of the parties pursuant to the agreement.

to govern their agreement to arbitrate and they have also opted the law which is to govern the arbitration proceedings.”

In its concluding paragraph, the minority judgment observed that although the proper law governed the validity of the arbitration agreement in the said case, any award by the arbitration council in favor of one party or another would be brought to Pakistan for execution, where it would be challengeable by either party on its validity on “any ground whatsoever” under Pakistani law¹⁵.

We do not aim to give our own judgment on the legal battle between WAPDA and HUBCO. Our attempt here is only to highlight the wide difference that existed on the interpretation of the law among the judges of the Supreme Court of Pakistan. Although the judgment was announced on June 14, 2000, the dispute could not be settled until December the same year¹⁶.

The poor handling of IPP cases and that of HUBCO in particular, had a negative effect on Pakistan’s image as an investor friendly country; the allegations hurled at the IPPs only served to erode investor confidence in Pakistan. (Fraser, 2005) The Government has been unsuccessful in attracting any major investment in the power generation sector since 1998.

3.44.4 Could any unnecessary costs have been avoided?

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The tariff rate agreed upon disguises the IPPs’ real cost to WAPDA and the public. It is likely that the capacity payment, which guaranteed the investors a good return on equity, gave the IPPs no incentive to be cost effective. Given that it is difficult to determine the real cost per unit of electricity produced by IPPs, it is impossible to establish how much lower the tariff could have been. However as renegotiations show, the tariff can be lowered while still giving the IPPs good returns. The argument that the Government had to offer indexation to inflation and the exchange rate to attract any investment at all could not be verified, but they definitely resulted in very high tariff rates.

The other major costs incurred were through the fiscal incentives. It can be argued that these incentives were needed to attract the IPPs in the first place. However, it remains unclear as to what extent they were needed. All that can be said is that the Government should have offered a clearer tariff structure that incorporated *all* benefits the IPPs were to get, into one clear tariff rate, or have provided detailed and reliable numbers of the costs of the IPPs to the public to make it possible to decide whether they were worth their costs or not. In hindsight, the massive amounts of public money spent on the IPPs may have been sufficient to finance higher capacity public plants. Therefore, the question that the IPPs should have been attracted, or WAPDA should have been supported, could be discussed again.

¹⁵ For details, see Supreme Court of Pakistan Judgement in Civil Appeals Nos. 1398 and 1399 of 1999, decided on June 14, 2000. See also, Pakistan Law Digest (PLD), Supreme Court 841, paragraph 46.

¹⁶ Kantor, 2001, p. 1,180.

45 New developments and problems

4.15.1 Today's situation

4.1.15.1.1

The

state of the private power sector

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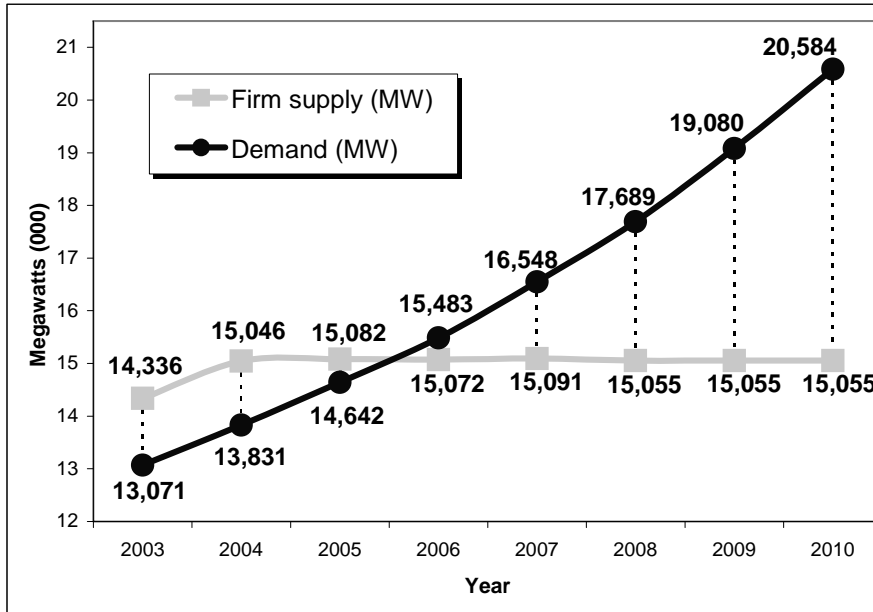
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Today, most of the IPPs have been commissioned, public organs like WAPDA are being restructured, and the tariff rates for WAPDA have been renegotiated. As mentioned above, WAPDA has to pay the IPPs one billion dollars annually in capacity payments. The same amount was paid in FY 2002–03. The consumer tariff rate on the other hand, has been rising. WAPDA has transferred much of the burden caused by inefficiencies to consumers (this has also been supported by the Government). In November 2001, the federal cabinet approved the establishment of a national task force to prepare an Integrated Energy Security Action Plan for the next ten years (Amin, 2001). This task force predicted a new shortfall in power for the coming years.

According to the PPIB, a major power deficit can be expected by 2005–2006.

Figure 1: Expected power demand and supply



Source: Adapted from PPIB, 2006a

4.1.25.1.2

2002 Power Policy

The

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Several new power policies emerged after 1994, but none of them affected the IPPs commissioned through the 1994 policy.

The 2002 Power Policy was based on the report of the 2001 National Task Force. Policymakers were careful not to specify any figures for required capacity, nor did they state a preference for public or private power, declaring such decisions to be contingent upon clearly established future demands. The Government is also promoting the concept of projects undertaken through public-private partnerships, allowing it to get the same conditions as solely private power generation projects. This is an improvement, as the benefits and drawbacks to new public or private plants can be evaluated on a case-by-case basis. The major change is that the bulk power tariff has been removed. International competitive bidding (ICB) will be used instead, which can benefit the consumer through lower electricity prices. The bidder with the lowest levelized tariff will be accepted.

Certain positive elements of the old policy, such as standardized agreements have been kept intact. In addition, the tariff will still consist of an energy and a capacity payment, and investors will still be guaranteed a certain return on equity. Other severely criticized elements like fiscal and financial incentives have also remained part of the new policy. They have received significant support because they are seen as necessary to attract investors.

One major criticism is that while the tariff is now denominated in Pakistani rupees, it is also indexed to the exchange rate of the US dollar. This means the tariff can still rise if rupee devaluation continues as before.

All IPPs under the 1994 policy were thermal power plants often using furnace oil as a fuel. This created a heavy dependence on oil prices. The new policy therefore encourages the use of indigenous fuels and hydel power projects. Hydel plants with their low variable costs are likely to be dispatched earlier than other plants as the decision is taken according to performance and costs indicators. This can also help indigenous fuels, as they may be cheaper. Furthermore, WAPDA carries the risk of water availability for plants with a capacity bigger than 50 MW (GoP, 2002).

A committee under the Secretary of Water and Power, consisting of representatives from PPIB, WAPDA, KESC, the Planning & Development division, the concerned provincial Private Power Cell (PPC) and the Sindh Coal Authority will be constituted to help the PPIB take decisions on various issues. This measure was taken to improve policy implementation (GoP, 2002). Thus while there are many improvements in the 2002 policy, some major problems remain unresolved. The tariff *still* does not reflect what IPPs cost the public exchequer.

4.25.2 The coming years

The coming years will see an increase in the private power generation sector. New investors have already started more projects. This shows that the 2002 policy *does* offer them conditions that allow them to develop financially viable projects. Investors may however be reluctant to invest due to the instability seen in the power sector in the past. Furthermore, there is no real evidence yet that the new competitive bidding process in the 2002 policy will actually result in cheaper electricity or not.

Other reforms are in the offing too. The Government plans to privatize the distribution companies (Discos), and later WAPDA. Many see this as the only solution to the power sector's inefficiencies. However, there have been no indications as to when this privatization will take place, or how much public money will be required to attract investors.

5.6 Conclusion and recommendations

There is hardly any doubt in the contention that the introduction of IPPs generated more questions than it answered. The experience of the past 15 years has important lessons.

Pakistan's history is full of instances where governments have formulated policies based on exaggerated growth models and misplaced assumptions, ultimately implementing them in a highly non-transparent manner. The long-term consequences are often ignored for short-term political and personal financial gains. The IPPs made, and are still making huge profits on virtually zero-risk investments. Governments since 1994 have accused each other of corruption, disloyalty, and political victimization, and absolved themselves of all responsibility. In the meantime, the public has been paying ever-rising electricity bills. The question remains: who should be blamed for this fiasco? The IPPs, the PPP or PML-N governments, or the World Bank? Whether or not this can be ascertained, one fact that comes out clearly in this investigation is that all power policies have been made in isolation. There was absolutely no effort on the part of the then governments to include independent institutions experienced in policy advisory, and knowledgeable in energy issues. There were no government studies to gauge public willingness to pay such high tariffs.

Power sector issues can be resolved by formulating fair and just policies. Looking ahead, taking mistakes of the past into account is the key to formulating such policies. Privatizing the thermal power sector while keeping large-scale hydro generation and the transmission business public, is not a complete solution. Privatization for one reason or the other is seen as a panacea for all ills by international donor organizations, and will invariably be manifested in our policies. This explains the Government's obsession with privatizing Discos.

5.16.1 Strengthening electricity regulation

NEPRA was formed in 1997 under an act passed by Parliament to regulate electricity prices in the country. However, its independence and authority have frequently been encroached upon by the Government. The government should take steps to strengthen NEPRA by decentralizing it,

making it more transparent and accountable to Parliament. The authority is currently based in Islamabad where it conducts all its hearings. It should be expanded to include offices where Disco headquarters are located.

5-26.2 Civil society empowerment

The secrecy among government officials on IPP issues is immense. It exists to such an extent that even the methodology used to calculate tariffs for the IPPs in 1994 remains unknown. The Government has not yet understood that transparency and accountability within public authorities would strengthen public trust in them. It would make needed reforms understandable to the general public.

5-36.3 Restructuring WAPDA

Decision-making power in WAPDA needs to respond to the market environment appropriately. Handing the reins over to army officials solves nothing. The army's induction in KESC and WAPDA management in 1997 and 1999 respectively, may have brought short-term gains, but the longer-term condition remains unchanged.

Restructuring WAPDA should not translate into the privatization of its various units. The power wing of WAPDA should be *decentralized* and divided into distribution, transmission, and generation. Privatization has been shown to lead to higher tariffs. This cannot be allowed, and it is the Government's duty to provide affordable electricity to all sections of society. Furthermore, it is imperative that the Government should consult with sector experts and civil society before embarking on any privatization programs.

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Appendix 1

The institutional framework of private power

The **Government of Pakistan** has the final say in the design and implementation of power policies. It provides general outlines, and intervenes in problematic situations. The Government is often seen as unreliable and unstable in the eyes of private investors due to frequent changes in leadership.

WAPDA and **KESC** are the IPPs' only customers. They were both state companies, although KESC was privatized in November 2005. They purchase electricity from the IPPs and are responsible for transmission and distribution to consumers. Founded in 1958, WAPDA is based in Lahore but its operations extend all over the country. The exception to this is Karachi and its surrounding areas where KESC takes over. Both organizations are being managed by army officials (Dawn, 2002).

The **WAPDA Private Power Organization (WPPO)**, essentially a part of WAPDA, was created to negotiate agreements with the IPPs. The PPIB took over most of its responsibilities later.

The **Ministry of Water and Power (MWP)** is the government ministry responsible for water and power. The **PPC** within the MWP was concerned with the private power sector. As with the WPPO, the PPIB has taken over the PPC's work.

Located in Islamabad, the **PPIB** was created under the 1994 Power Policy. A part of the MWP, it is responsible for coordinating with international organizations, local ministries and IPPs, with monitoring IPP performance in accordance with their agreements, and safeguarding the interests of consumers. The PPIB and WAPDA jointly develop future visions, strategies, and policies for power generation in the country.

The **Planning Commission** is a government institution that carries out long-term planning and advises the Government on matters pertaining to infrastructure development.

The **Privatisation Commission** is a government body "entrusted with selling federal government property...in an open and transparent manner" (PPIB, 2006b). It is therefore also responsible for dealing with the privatization of the public power sector too.

NEPRA is an independent Islamabad based organization that was founded in 1997 but already planned in the 1994 report by the Task Force on energy, to provide transparent and judicious economic regulations to the power sector of Pakistan. NEPRA's main responsibilities are to:

1. Issue licenses for generation, transmission, and distribution of electric power;
2. Establish and enforce standards to ensure quality and safety in operations and the supply of electricity to consumers;
3. Approve the investment and power acquisition programs of utility companies;
4. Determine tariffs for generation, transmission, and distribution of electricity (NEPRA, 2006).

The **NDFC** used to administer the **LTFCF**, a fund that paid for the PSEDP 1 and 2. It received money from the **World Bank** and various foreign governments and banks. The LTFCF is controlled by the

NBP, now that it [the NBP] has merged with the NDFC. The World Bank also funded some power projects directly and gave policy advice to the GoP.

Appendix 2

List of IPPs

Apart from the IPPs that came into being after 1994, there are two more private power generation companies: HUBCO and KAPCO.

There is a total installed capacity of 17,726 MW in Pakistan. The commissioned IPPs (including HUBCO and KAPCO) contribute about 5,800 MW to this figure. WAPDA and KESC are the sole buyers.

Table 4: List of IPPs

| | Name | Capacity (MW) | Commissioning Date | Term of project/PPA (years) |
|----|--|---------------|--|-----------------------------|
| 1 | AES Lal Pir Ltd. | 362 | November 6, 1997 | 30 |
| 2 | AES Pak Gen. (Pvt.) Ltd. | 365 | February 1, 1998 | 30 |
| 3 | Altern Energy Ltd. | 14 | June 6, 2001 | 30 |
| 4 | Davis Energen (Pvt.) Ltd. | 10 | Not commissioned | 25 |
| 5 | Eeshatech (Pvt.) Ltd. | 20 | Not commissioned | - |
| 6 | Fauji Kabirwala Power Co. | 157 | October 21, 1999 | 30 |
| 7 | Gul Ahmed Energy Ltd. (GAEL) | 136 | November 3, 1997 | 22 |
| 8 | Habibullah Coastal Power (Pvt) Ltd. | 140 | September 11, 1999 | 30 |
| 9 | Japan Power Generation (Pvt.) Ltd. | 135 | March 14, 2000 | 30 |
| 10 | Kohinoor Energy Ltd. | 131 | June 20, 1997 | 22 |
| 11 | Liberty Power Project | 235 | September 10, 2001 | 25 |
| 12 | Northern Electric Co. Ltd. | 6 | 2003 | 30 |
| 13 | Power Generation Systems Ltd. | 116 | Not commissioned | 22 |
| 14 | Rousch (Pakistan) Power Ltd. | 412 | December 11, 1999 | 30 |
| 15 | Saba Power Co. Ltd. | 125 | December 31, 1999 | 30 |
| 16 | Sabah Shipyard Pakistan Ltd. | 288 | Not commissioned | - |
| 17 | Southern Electric Power Co. Ltd. (SECPCOL) | 117 | July 12, 1999 | 30 |
| 18 | Tapal Energy Limited | 126 | June 20, 1997 | 22 |
| 19 | Uch Power Limited | 586 | October 18, 2000 | 30 |
| 20 | HUBCO | 1,292 | March 31, 1997 (not 1994 policy) | 30 |
| 21 | KAPCO | 1,466 | First public plant, later privatized, different parts commissioned between 1994 and 1995 | 25 |

Source: PPIB, WAPDA, and the World Bank.

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