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DRAFT

DESIGN OF AN ELECTRIC POWER REGULATORY SYSTEM FOR PAKISTAN

TRIP REPORT

INTERNATIONAL RESOURCES GROUP, INC.
PUTNAM, HAYES & BARTLETT, INC.
HUNTON & WILLIAMS

July 4
~~JUNE~~ 23, 1992

INTRODUCTION

The Government of Pakistan has embarked on an initiative to privatise the electric power sector in Pakistan. An important part of this process is the creation of a national regulatory authority. The International Resources Group has been retained to design the national regulatory authority by April 1, 1993.

The regulatory authority will be designed using a stepped approach intended to further close cooperation among all relevant GOP institutions. The first step is to define the regulatory objectives and tasks in light of the industry structure recommended in the Strategic Plan submitted to the GOP by WAPDA in April 1992 as approved by the Cabinet Committee on Energy on July 18, 1992.

To achieve this first step, the IRG Team submitted a working paper on the objectives and tasks of regulation in June 1992. The Team then travelled to England and Pakistan for extensive discussions with GOP and Provincial officials as well as various other interested parties. These discussions took place between July 10 and July 23, 1992. The Team consisted of

Dr. Charles Ebinger - Team Leader
Mr. Arun Banskota - IRG
Dr. George Hall - Putnam, Hayes and Bartlett, Inc.
Mr. Robert Fitzgibbons - Hunton & Williams
Ms. Laura Wilson - Hunton & Williams

Specific issues examined during the July trip of the Team at the meetings reported on here included.

- o The regulatory tasks to be associated with the proposed, restructured electric power industry in Pakistan and attendent regulatory objectives and goals,
- o The options available to allow the regulatory authority to achieve its objectives; including rate regulation methodology, technical and performance standards, and enforcement provisions and authority,
- o How to ensure an independent status for the regulatory authority in the GOP, the relationship of the authority to other GOP bodies charged with regulation of industry, the authorities supporting staff, selection, approval process and tenure for the members and chairman, as well as the proposed budget funding and approval process.

Meetings were held in Islamabad, Peshawar, Lahore, Karachi and London. This Trip Report summaries the substance of the discussions.

TRIP REPORT

July 9, 1992

Meeting with Overseas Development Administration
U.K. Government
94 Victoria St.
London SW 1E 5JL

Attendees: RGM Manning, ODA
Under Secretary Asia and Pacific Division

Gareth Aicken, ODA
Section Head, Pakistan

Harry M. Hagan
Economist Asia and Ocean Economic Dept.

Robert (Bob) Irvine
Deputy Director for Scotland
Office of Electricity Regulation
48 St. Vincent Street
Glasgow G2 571 Scotland

Charles Ebinger
Rob Fitzgibbons
George Hall
Laura Wilson
Arun Banskota

The first part of the meeting dealt with (1) the objectives of the IRG Team (Team) trip to Pakistan and (2) ODA's intentions regarding electric power privatisation in Pakistan. Dr. Ebinger reviewed the Strategic Plan and explained that the purpose of the upcoming trip was to consult with various interested parties of particularly the provincial governments, and to obtain all relevant views about the regulatory authority prior to drafting a report and proposal. Dr. Ebinger stressed the need to obtain a firm timetable for implementing the Strategic Plan and especially for establishing the regulatory regime.

Mr. Manning stated that, although ODA has a strong interest in the privatisation of WAPDA, ODA is concerned with the viability of privatisation in terms of whether the political process in Pakistan will accommodate privatisation. He noted that a critical factor is whether the Government of Pakistan makes appropriate decisions at each stage, such as identification of a head of the regulatory authority. The Group interpreted his comments to mean that ODA is principally concerned with whether Pakistan adopts the British model for privatisation and, particularly, regulation.

Mr. Manning noted that, in light of ODA's concerns about viability of the privatisation and regulatory development process ODA had not reached a decision about the appropriate role for ODA. He noted that a potential budget of approximately $1 million had been discussed and that, if ODA is interested at all, it would probably be interested in funding a discrete portion of the project. He also mentioned the possibility of collaboration with the Asian Development Bank. According to Mr. Manning, ODA will wait until the Team paper on the design of the regulatory agency is available in September 1992 before assessing whether the privatisation is viable and therefore whether to provide follow-on funding and, if so, how much to contribute.

Mr. Manning's views were reiterated by Mr. Aicken. In all, it appeared that ODA strongly supported the views in Mr. Irvine's recent report on regulatory matters. Unless the Pakistan scheme is compatible with Mr. Irvine's views, which strongly advocate the British model for privatization, it appears questionable whether ODA will support the project.

Mr. Irvine then outlined his ideas. He stressed that, to attract foreign capital, both the electric power industry and related government structures must be professionalised and modernised. Mr. Aicken suggested that ODA might wish to contribute to that effort. Mr. Irvine also noted that, while competition is desirable as a long term goal, competition is not practical in the short term, as evidenced by the fact that competition is not occurring in the U.K.

The second part of the meeting, which did not include Mr. Manning, covered Mr. Irvine's views of a desirable regulatory regime for the privatised Pakistan electric power sector. Mr. Irvine questioned the GOP's commitment to privatisation as well as the ability of the industrial and governmental machinery to make the necessary decisions.

Mr. Irvine believes that independence of a regulatory authority is undesirable and impossible. He believes that the political branch of the government should have ongoing involvement in defining the tasks of the regulatory authority, although that involvement should take the form of periodic review rather than daily involvement. For example, he suggested that there can be a five year regulatory contract or charter between the GOP and the regulatory authority which will closely define the goals of the authority. He also discussed the possibility of hiring a private contractor as a regulatory authority.

There was a discussion of the various ways in which the political branch of the government can be involved in oversight of the regulatory agency, such as (1) by limiting the duration of the regulatory authority's powers through a predetermined expiration date, (2) by subjecting actions of the regulatory authority to legislative veto, or (3) by requiring the regulatory authority to prove that regulatory goals are being achieved. The Team emphasized that a critical issue is how to structure the regulatory authority so that utilities that are regulated under that authority are protected from political changes and the resulting uncertainty regarding sanctity of contracts.

The discussion about protecting investors through regulation led to a general discussion of whether utilities desire to be regulated. One question is the degree to which various forms of regulation create a preference among utilities for regulation, since pervasive regulation limits a utility's risks, i.e., reduces accountability, and therefore may result in inefficiency. In that context, Mr. Irvine referred to the U.K.'s scheme of licensing, under which utilities are relatively autonomous. Licenses in the U.K. specify utilities' responsibilities by establishing rates, defining their authority to change prices, and by defining obligations to provide transmission service.

Next, there was a discussion of the role of the provinces in regulation. Mr. Aicken remarked that Pakistan is not one country but four provinces, and that WAPDA is the fifth province. The new, national regulatory authority would change the balance of power. The options that were discussed regarding the role of the provinces included (1) membership of representatives of the provinces on an advisory board to the national regulatory authority and (2) requiring the regulatory authority to consult with the provinces.

As far as prioritizing the tasks in implementing privatization, Mr. Hagan suggested that the most important task is achieving economic price regulation. Mr. Irvine does not recommend pooling as employed in the U.K. because the U.K. model does not create adequate incentives to maximize efficiency from existing units. However, Mr. Irvine recommends pooling in some form. Mr. Hagan suggested that the second task should be defining the role of the regulatory authority in negotiating the sale of existing power plants as well as the development of new power plants.

Finally, logistics were discussed. ODA recommended that the Team consult with the British High Commissioner, talk to ODA on the way to the U.S. if possible, and send ODA the IRG Team trip report, including a report on how committed the GOP is to privatisation.

<u>July 12, 1992</u>

(1) Meeting with McFarlane Croup
Islamabad Holiday Inn

Attendees: Robert McFarlane
Woody Pierce
John Hawkins

C. Ebinger
R. Fitzgibbons

Bud McFarlane reported on his group's efforts to purchase one of WAPDA's generation plants. Apparently, the McFarlane Group is no longer interested in the Jamshoro plant any to the local political situation. The Group's efforts are now focused on the Kot Addu plant. The Group wants the corporatisation and purchase of Kot Addu to occur simultaneously. The Group is willing to incur the expense of corporatising the plant.

Mr. McFarlane reported that his group had met with the highest levels of the GOP and that he believed the creation of the regulatory framework is critically important to the timely sale of WAPDA's assets. Mr. Hawkins concurred in this assessment, and added that he believed the regulatory framework should parallel the cost-based regime that encouraged the successful growth of electric utilities in the United States. The group seeks a form of regulation that will ensure investors a "reasonable return" on their investment. Tariffs will, as in the United States, be adjusted periodically to recover capital costs plus a rate of return that is adjusted to reflect the risks associated with investing in power projects in Pakistan.

The group strongly advocated this rate-of-return approach to tariff regulation as a means of ensuring that the new power company is financially viable. Messrs. Hawkins and Pierce believe that this approach will enable appreciation of stock value, and that stock appreciation will generate capital for new power projects. They believed that this approach will allow the new corporation to list its stock on the American Stock Exchange thereby enabling the Pakistan power sector to access the international capital market more easily. Mr. Pierce did not like the fixed-rate contracts (and project-oriented finance) that now characterises independent power projects worldwide.

Mr. McFarlane recognized that some sort of international competition for Kot Addu is necessary for the credibility of the privatisation process. However, Mr. McFarlane believed that the privatisation process outlined in the Strategic Plan (corporatisation with operation by O&M contractor prior to sale of asset) is unnecessary and will take too long. The Group suggested instead that the GOP solicit purchase offers and develop a list of pre-qualifications (with the aid of a financial advisor) that will be used to screen offers.

This discussion led to the topic of the specifics of a schedule for Kot Addu. The Group wanted the pre-qualifications to be developed within the next few months and suggested a thirty day period for bids to be submitted in response to the solicitaction. The delay of obtaining a financial advisor for Jamshoro was of concern to the Group. The Team reminded Mr. Mc Farlane that developers in the U.S. often pick up the cost of the advisors to the utilities purchasing power as part of the costs of financing an independent power project.

(2) Meeting with World Bank
Islamabad

Attendees: Z. Ladhibi-Belk
C. Ebinger
R. Fitzgibbons

The Team updated the World Bank on the Team's privatisation efforts, including the GOP's acceptance of the Strategic Plan, the corporatization of Jamshoro, and the creation of the National Electric Power Regulatory Authority. The World Bank, in turn, informed the Team that the World Bank was in the process of negotiating the conditions of the World Bank's next loan to the GOP energy sector with the GOP. The Team learned that several conditions were being considered, including the GOP's endorsement of the Strategic Plan, the development of legislation for the corporatisation of Jamshoro, creation of the regulatory authority, and development of an implementation plan.

It was clear that corporatisation of WAPDA and creation of the regulatory authority are the World Bank's top two priorities. It was represented that the Bank would believe that real progress is being be made if these tasks can be accomplished in the next two years. On the other hand, Ms. Ladhibi-Belk indicated that the GOP will have to make several major decisions now in order to achieve this goal.

Ms. Ladhibi-Belk also indicated that the Bank had provided comments to the GOP on the regulatory authority and the implementation plan. The Bank recognises that the Privatisation Committee (Power Sector) (PSPC) needs technical assistance, including legal, technical and financial advisors. The Team reported on its meeting with ODA and ODA's statement that it had not yet decided whether to fund Phase II of the regulatory work. Ms. Ladhibi-Belk indicated that this would not become a problem and that the World Bank can pick up the funding. In addition, Ms. Ladhibi-Belk, indicated that the Bank will be willing to fund programs to minimize labor problems that will be generated by privatisation, including helping to set up new businesses and retraining staff.

The discussion next turned to the corporatization/ privatisation of Jamshoro and the availability of Morgan Stanley. Ms. Ladhibi-Belk indicated that the ball was now in Morgan Stanley's court. No indication was given as to when Morgan Stanley would become involved. The Team reported on the meeting with Bud McFarlane and the possibility of privatisation of a power project other than Jamshoro. Ms. Ladhibi-Belk responded that such an effort should not be permitted to delay corporatisation of WAPDA and Jamshoro.

July 13, 1992

(1) Meeting with U.S. Agency for International Development, Islamabad

Attendees: Ken Lussier
Mian Shahid Ahmad
Randall C. Cummings

Robert Grimshaw
Andres Doernberg
Steven Skidmore
Charles Ebinger
Rob Fitzgibbons
George Hall
Laura Wilson
Arun Banskota

The meeting focused on GOP endorsement of the Strategic Plan. Mr. Lussier explained the extreme importance that AID has placed on clarifying the status of the Strategic Plan. Mr. Lussier stressed the need for (1) clarification of the role of the privatisation committee and the authority of Mr. Mahsud and the privatisation committee (2) a political commitment to privatisation, and (3) formal approval of the Strategic Plan.

The Team reported that a group led by Bud McFarlane is in Pakistan discussing the purchase of generation facilities other than Jamshoro. The McFarlane Group apparently is interested in selling power from the purchased units to WAPDA under a U.S. style cost-of-service contract.

Scheduled meetings and logistics of the Team's trip in Pakistan were discussed. It was suggested that the Team prepare a short document highlighting the key points of the working paper on establishing a regulatory authority.

AID also suggested that the final report on the regulatory authority include model standardised licenses for participants in the power sector, as well as the legislation to create the regulatory authority.

(2) Meeting with M.A. Rashid, Chief Economist, Baluchistan Province

Attendees:
Robert Grimshaw
Andres Doernberg
Steven Skidmore
Charles Ebinger
Rob Fitzgibbons
George Hall
Laura Wilson
Arun Banskota

The meeting began with Mr. Fitzgibbons outlining the salient features of the Strategic Plan and regulatory regime. Mr. Rashid expressed confidence in his province's representation in the Federal government. Mr. Rashid also emphasized the cooperative fashion in which Baluchistan has been involved in the Hab River Project.

Mr. Rashid described the electric power sector in Baluchistan. Development of the electric power sector is a top priority in Baluchistan, and the government is seeking privatization to expand service to presently unserved areas. Many valleys still need to be electrified, Baluchistan is rich in coal and needs power stations. Currently, the province provides funding to support WAPDA's activities in the area. Mr. Rashid suggested that it might be less expensive to work directly with private companies.

Mr. Rashid believes that, consistent with efforts toward decentralization of authority in matters such as education and health, the electric power sector should be regulated at the provincial rather than federal level. However, what was meant by this statement was not entirely clear. Mr. Rashid seemed primarily concerned with regulation of distribution companies. He referred to the provincial Department of Irrigation and Power which conducts inspections of electrical facilities. However, Mr. Rashid had the impression that WAPDA will continue to sell to the distribution companies and that these rates will be passed along to consumers without provincial regulation. Mr. Rashid did not express any opposition to federal regulation of rates for sales and services over the transmission grid.

When asked whether Baluchistan will subsidize customers that can not afford power, Mr. Rashid reiterated that Baluchistan already provides funding to WAPDA. He indicated a willingness to provide more subsidies. He also broadly stated that Baluchistan will support privatisation but not at the expense of consumers. Mr. Rashid expressed the presumption, that privatisation will lead to lower prices through increased efficiencies (which the Team believes to be an incorrect assumption). Mr. Rashid's statements regarding the province's willingness to provide subsidies may be based on the assumption that improved efficiencies will provide the funds necessary to support subsidies.

(3) Meeting with S.A. Sheikh, Ombudsman Secretariat

Attendees:
Robert Grimshaw
Andres Doernberg
Steven Skidmore
Charles Ebinger
Rob Fitzgibbons
George Hall
Laura Wilson
Arun Banskota

Mr. Sheik described the objectives and function of the Ombudsman - a constitutional office having special rights and abilities that a regulating agency established by law does not possess. He expressed the view that it will be hard to obtain constitutional status for the proposed regulatory authority.

The Ombudsman listens to any complaint, no matter how informally presented, against any governmental entity. It has no jurisdiction over non-governmental organizations. The Ombudsman reports the complaint to the agency involved, receives a reply, and renders an equitable judgment. A request for reconsideration can be made. After a decision on reconsideration, the decision can be taken to the President who will then act as the final level of appeal. The President's decision is final and can not be appealed to court, except if a party has been held in contempt.

The significance of an Ombudsman's decision is accountability. A discussion by the Ombudsman against an agency is recorded on a government employee's service record and adversely impacts career prospects.

Mr. Sheikh explained that the Ombudsman makes equitable judgements. It is not a court of law.

Mr. Sheikh said there were two routes to establishing a regulatory authority. Like the Ombudsman, it can be a constitutional office, but that requires a 66 percent majority of both legislative houses and he did not think that such a majority was possible. The second alternative was to enact legislation, such as an amendment to the WAPDA Act. Legislation must be sponsored by a Ministry.

The Ombudsman's Office has an administrative officer dedicated to handling complaints against WAPDA. The team asked for data on the number and types of complaints that are lodged against WAPDA. Mr. Sheikh promised he would provide the data. Mr. Doernberg is to follow-up. Interestingly, WAPDA can file complaints against other governmental entities including entities which have not paid their bills.

The Ombudsman's budget goes to the Ministry of Finance and then to the President for approval. Apparently, parliament does not have an opportunity to review and approve the Ombudsman's budget. The funding level is apparently the President's decision. There was a discussion of the leverage the Ministry has over the Ombudsman because of the budgetary process. Mr. Sheikh sees this as a major problem.

There was a long and detailed discussion of the role of the Ombudsmen in relation to a potential regulatory agency. He cited as an example a complaint that the Ombudsmen took up against the Pakistan railroad about a delayed package. Mr. Sheikh was asked whether the Ombudsman would address a complaint if the problem was not a failure of the railroad to perform properly, but rather an objection to the lawful rate charged by the railroad or its efficiency generally. Mr. Sheikh believed that the Ombudsman can investigate these matters. Mr. Sheikh also believed that the Ombudsman could investigate actions of a regulatory authority.

Mr. Sheikh put forth a message that has important implications for the regulatory authority and its autonomy. Under the present GOP system, if an Ombudsmen were concerned about the substance of a decision of the regulatory authority there is no way to prevent the Ombudsman taking the decision to the President for review.

Finally, the Team discussed the advisability of a single administrator or a multi member commission structure for the regulatory authority, based on Mr. Sheikh's experience at the Ombudsman office. Mr. Sheikh recommended the commission structure.

(4) Meeting with Privatisation Commission (Power Sector)
IRG - Islamabad

Attendees:
Mr. Rahim Mahsud, Chairman PC(PS)
Mr. Qazi Aleemullah, Finance Secretary, Ministry of Finance
Mr. M.A. Jabbar, Acting Secretary PC(PS)
Mr. Mumtaz Hamid, Chairman WAPDA

C. Ebinger
B. Grimshaw
R. Fitzgibbons
G. Hall
L. Wilson
L. Ruff
A. Banskota
K. Lussier
Mian Shahid Ahmad

Mr. Mahsud began the meeting with a strong statement that NEPRA is vital and that the private sector must know the degree to which it will be subject to regulation. Mr. Qazi Alimullah then emphasized that the scope of NEPRA's responsibilities should be limited to the electric power sector. This led to a discussion of the autonomy or independence proposed for the regulatory authority. Mr. Alimullah argued one point particularly forcefully; namely, that an autonomous/independent regulatory authority is inconsistent with Pakistan's parliamentary form of government and undesirable. The cabinet is a body of parliament and Mr. Allimullah opined that the regulatory authority must therefore report and take direction from a Ministry. He repeatedly emphasized that "there must be a place for policy direction from the Government" and that the regulatory authority cannot be "above the law".

Mr. Allimullah's views were not shared by any of the other members of the PCPS. It was the view of the rest of the attendees, including Mr. Haneef, Chairman WAPDA, and Mr. Mahsud, that an autonomous, independent authority is both lawful and desirable. A distinction was drawn by Mr. Allimullah between adjudication (which is not subject to the direction of the government) and policy formation. Mr. Allimullah's proposition was debated at considerable length.

On a related issue, Mr. Allimullah suggested that the Government should establish a maximum electricity price and a minimum electricity price. The regulatory entity will have the limited ability to establish a specific tariff between the politically established floor and ceiling. In addition, Mr. Allimullah suggested that the government should be able to revise periodically the floor and ceiling. This position was not supported by any other person at the meeting. According to the Chairman WAPDA, for example, the regulatory authority should be subject to the minimum of political interference while the country moves out of its electricity crises.

Chairman WAPDA and Mr. Mahsud suggested that policies on rates should be incorporated into laws at the commencement of the privatisation process and that the government should not interfere with execution of NEPRA in carrying out its Statutory authority. Chairman WAPDA also stated that the budget of NEPRA should be independent from Ministerial control but that activities of the regulatory authority will need to be audited. The Team strongly endorsed Chairman WAPDA's position and explained that insulation from the political process was critical for the regulatory stability needed to encourage private investment in the power sector. Mr. Hall also pointed out that the approach advocated by Mr. Allimullah scarifies one of the features of a regulatory authority most attractive to politicians - the ability to insulate themselves from politically difficult (but necessary) reforms. There was a consensus that the regulatory authority must be subject to judicial review and that it is advisable for the regulatory authority to be given precise criteria that will serve as the basis for regulatory rates. In addition, the process for regulating rates must be transparent.

With regard to regulatory objectives, the PCPS generally endorsed the working paper. Mr. Allimullah emphasized three tasks:

- Safety and enforcement;

- Fair compensation to power generators and distribution companies; and
- Consumer protection and control of monopoly power.

There was general agreement that the regulatory authority should provide an annual or periodic report to the government. Mr. Mahsud also suggested that the regulatory authority may have to satisfy a planning function.

The PCPS recognizes that responsible environmental regulation is critical and that the Pakistan Environmental Protection Agency (PEPA) is very weak. The Team summarized the advantages and disadvantages of making NEPRA responsible for environmental regulation of the electric power sector. The PCPS expressed its interest in obtaining the Team's recommendation regarding whether the regulatory authority should be responsible for environmental regulation.

The role of the provincial governments was also examined. The PCPA reported that under the constitution the provincial governments can take over the distribution companies and that this fact must be taken into account. The PCPS opined that advisory panels should be investigated.

The discussion also focused on the Strategic Plan. It was explained to the Team that the GOP was seriously interested in

(a) privatisation of assets more rapidly than the timetable proposed in the Strategic Plan, and (b) selling smaller power generation facilities immediately rather than making Jamshoro the first sale.

The GOP's interest in a "fast track" privatisation program was discussed extensively. The Team stated that it was the Team's view that "fast track" privatisation will not enable the GOP to get full value for its assets. Experience worldwide demonstrates that corporatisation yields efficiencies that enhance the value of government assets. The Group also emphasized that undervaluation of assets can undermine the credibility of the privatisation program and fast track sales can result in arrangements that may be inconsistent with the competitive structure of the industry recommended in the Strategic Plan (e.g. cost-based contracts with generating companies subject to regulation even after competition is established).

The PCPS stated that the government understood the risks of fast tracking. Indeed, Mr. Mahsud and Chairman WAPDA expressed concern about the risk, but reported that the GOP was interested in selling projects immediately in order to raise capital for social investments in health, education, etc.

The Team asked the PCPS whether the GOP's interest in "fast track" privatization indicated a change in the GOP's position or a rejection of the Strategic Plan. The answer given was no. Later, the PCPS indicated that the Implementation Plan should include a "fast-track" option for small generation plants in addition to the schedule for privatisation included in the Strategic Plan. The PCPS instructed the Team to move ahead to develop (1) a fast track schedule for small generation and (2) the regulatory scheme. The Team agreed. The PCPS also suggested that Mr. Grimshaw and Dr. Ebinger should participate in the Cabinet Committee meeting scheduled for the following Saturday.

<u>July 14, 1992</u>

Corporate Law Authority Meeting

Attendees: Mian Mumtaz Abdullah, Chairman
Khalid Masood, Member

L. Wilson
G. Hall

The Corporate Law Authority is a commission that has three members and about two hundred and fifty staff. Chairman Abdullah explained that the Commission administers four laws covering three primary areas of economic regulation:

- Security regulation (like US Security and Exchange Commission);
- Monopoly and competition regulations; and
- Corporate regulation.

Each function has a separate staff reporting to a staff chief, with in turn reports to a Member of the Commission and, through the Member, to the Chairman. The Commission works by consensus.

The chairman is a lawyer. The other two members are an MBA and an accountant, respectively. There is no particular requirement to have lawyers on the Authority; a person of any relevant profession may be selected for membership.

The Authority is an "attached department", that is, it is attached to, but independent from, the Ministry of Finance. However, the Ministry of Finance approves the budget for the Authority. The Authority is vested by law with power that the Ministry of Finance can not take away. The Chairman explained that "The law protects me". He also said: "Law is supreme, not the policy, not the individual."

As an example of its autonomy or independence, Chairman Abdullah cited the rights that the Commission gave the Islamabad

Stock Exchange to operate. The Commission awarded these rights to a party not favored by the Government in power at the time.

Authority Members serve for five years, but can be removed for certain reasons. The Chairman strongly urged that the members of the proposed regulatory authority should only be able to be removed for malfeasance.

The Chairman distinguished between an "attached department" such as the Corporate Law Authority and an "autonomous" entity. Examples of an autonomous entities include:

- WAPDA; and the
- Civil Aviation Authority

An "autonomous" body does not have the same responsibilities to a Ministry as an "attached" department. An autonomous agency is self-financed Autonomous agencies can go to the government directly. Both the Chairman and Mr. Masood suggested that the electricity regulatory authority should be autonomous.

The Chairman stated that there are three requirements for independence:

- Members should not be removable except for cause;

- Power should emanate from laws and not through a delegation of authority from another governmental agency, ministry or department; and
- Financial independence.

There was discussion of the Monopolies Act. The Commission has been enforcing this law in a "low key" manner because all monopolies had been government owned. With privatisation, the commission is moving into a "high key" mode.

A critical element of the market analysis applied by the Corporate Law Authority is the definition of what is a monopoly Monopolies are generally viewed as controlling a third or more of the total national market. The significance of this definition is clear. The distribution companies will be given exclusive service franchises, but will probably not be viewed as monopolies subject to regulation by the Corporate Law Authority. It was also explained that the Corporate Law Authority can examine pricing by monopolies, but will not do so if another agency has such authority. Thus, the law authorizing the regulatory commission to regulate tariffs should exempt firms under its jurisdiction from the jurisdiction of the Corporate Law Authority.

July 15, 1992

(1) Meeting with Ministry of Water and Power
Islamabad

Attendees:
S.R. Poonegar, Secretary
Daud Beg, Additional Secretary
Shahid Hafeez, Acting Director General - Private Power Cell
Bob Marshall, British High Commissioner

R. Grimshaw
G. Hall
C. Ebinger
R. Fitzgibbons
A. Banskota

Before Secretary Poonegar's arrival, various concerns were expressed, including:

- The terms of reference for the Privatisation Commission (PCPS), including its responsibilities and authority;
- The limited resources and mandate available to the PCPS;
- The potential conflict between the NEPRA and the PCPS. The latter has the task to sell the assets. Mr. Beg believed that you could not ask the same organization to regulate these assets;
- The need to coordinate the roles and authorities of the Ministry of Water and Power (MWP) and the PCPS. To make progress, one agency should be given the primary

role in creating the regulatory authority and implementing the Strategic Plan; and

- The availability of the members of the PCPS; all of whom have other responsibilities likely to have a higher priority than the PCPS.

As expected, the internal organization of the privatization process and the supervision of the privatized companies are matters of great interest to the GOP. Each GOP entity wants to maximize its role in the process. The logic of how an independent regulatory entity is to relate to the GOP must be thought through carefully and explained thoroughly.

There was a discussion of differences regarding the World Bank's views about issues to be considered by consultants and who should supervise those consultants. Mr. Grimshaw stated that Chairman WAPDA wanted to streamline the privatisation process.

Secretary Poonegar joined the group and the main meeting began. Dr. Ebinger outlined the working paper on regulation. It was emphasized that all conceivable potential regulatory functions were listed in the working paper and not all functions should necessarily be performed by the NEPRA.

Mr. Poonegar stated that producers will have to be regulated at the beginning. A general discussion followed in which it was pointed out that regulation will focus on the contracts between power producers and power purchasers. The Team emphasized the NEPRA will have an important role in ensuring that all power sector participants satisfied their service obligations. Licensing of power sector participants will be used to define such service obligations.

The Team emphasized that approval of the Strategic Plan is vital to the tasks of (1) developing the Implementation Plan and (2) designing the NEPRA. It is virtually impossible to accomplish either task without a clear understanding as to the intended structure the industry. Mr. Poonegar stated that the Strategic Plan had been sent to the Cabinet. Later it was stated that the plan was scheduled to be considered on July 18, 1992 and representatives of the Team were invited to attend the meeting and to make a presentation.

There was extensive discussion of the functions that a regulatory authority should perform. Environmental regulation was of particular concern to Secretary Poonegar. Secretary Poonegar expressed a strong preference for an environmental cell within the NEPRA. Secretary Poonegar explained that PEPA is very weak and does not have electricity expertise.

Secretary Poonegar also raised the issue of whether NEPRA should have rate-setting authority. Secretary Poonegar expressed skepticism about whether NEPRA ought to have the authority to approve rates. Instead, it seemed to him that the NEPRA should merely recommend rates to the cabinet. Messrs. Hall and Fitzgibbons argued strongly that NEPRA rate-setting authority was necessary to insulate the rate setting process from political control. This insulation would be in the best interests of both the private sector and politicians because of the controversial and difficult nature of rate decisions. Absent such insulation, regulatory certainty will be difficult to achieve and the risks associated with power projects will increase.

There was a general agreement that the autonomy of NEPRA can best be achieved though a legislative act. There was also a discussion as to how the NEPRA should be funded. The Team responded that it can be funded by "user charges" in the electric power sector with NEPRA's budget reviewed directly by Parliament. A discussion as to the size of the NEPRA's staff followed with Mr. Hall providing examples from several countries.

Secretary Poonegar had obviously given a lot of thought to the regulatory authority. Secretary Poonegar systematically went through a list of questions. After discussion of each topic, Secretary Poonegar opined that:

- light-handed regulation is the preferred course;

- NEPRA should regulate hydel projects;
- NEPRA should be responsible for environmental regulation of the power sector (because PEPA lacks relevant expertise);
- NEPRA's regulatory responsibility should be limited to the electric power sector.
- NEPRA should be an autonomous entity like WAPDA;
- Regulation should be a federal function;
- NEPRA should be a multi-member commission rather than a single administrator, with representation from the provincial governments;
- NEPRA should issue licenses to participants in the electric power sector;
- Resolution of contractual disputes should be left to the courts; and
- The Cabinet should control rates.

A discussion on the role of the provincial governments followed. There are provincial electric inspectors that deal with complaints about WAPDA (both billings and service). Secretary Poonegar strongly urged that NEPRA should not take over these functions to avoid becoming overwhelmed by details.

How to integrate provincial governments into the regulatory process was discussed. Several approaches were explored, including: advisory committees, participation in proceedings, and membership on the Commission.

There was a discussion as to the need for the NEPRA to have a strong technical staff and Pakistan's need for an electrical code. Development of such a code was advocated by Mr. Hafeez as an important role for NEPRA. There was a general discussion as to whether individual power projects should be licensed. The consensus appeared to be that such licensing would only be necessary to ensure compliance with environmental requirements.

The issues associated with subsidies and cross-subsidies were analyzed. Secretary Poonegar stated that he feared that the private sector might be directed by the GOP to provide uneconomic services which, while socially desirable, are unprofitable. Unless the GOP were to pay for these services, the private companies will either not engage in the services or will have to abuse their market power in order to generate sufficient revenue to cover the cost of the unprofitable services.

Finally, the rulemaking authority of the NEPRA was raised by Secretary Poonegar. Secretary Poonegar opined that it is usual in Pakistan for an agency such as the NEPRA to be given rulemaking authority.

(2) Meeting with Energy Wing, Planning and Development

Attendees: Mr. Asfaq Mahmood, Senior Chief
Masood A. Malik, General Energy Advisor, USAID

C. Ebinger
G. Hall
R. Fitzgibbons

Before Mr. Mahmood joined the meeting his staff opined that electricity tariffs should be set on a scientific basis by the NEPRA rather than the government on the basis of social criteria. His staff also stated that the Privatisation Commission should not evolve into the regulatory body. Regulation required technical competence and the PCPS lacked this competence. He believed the NEPRA should be independent by being directly under the Cabinet with funding through the Ministry of Finance but not controlled by the Ministry. Electric taxes could be used to fund the regulatory activity, but this could increase electric rates too much.

After Mr. Mahmood joined the meeting, Dr. Ebinger went through the paper on the regulatory system. Mr. Mahmood asked a number of penetrating questions. He also asked for examples as to what regulatory authorities do in other countries. Afterwards, he stated he had not been able to think through the difficult issues in order to reach firm conclusions. However, he offered the following tentative views.

- Insulation of a regulatory authority from political interference in Pakistan is the most difficult task. Appointees will not really be independent of those responsible for their appointment. Further, to be independent, the regulatory authority must be created by and report to Parliament.
- A fundamental question for Mr. Mahmood is whether the regulatory authority or the government should be responsible for setting tariffs. The Team explained the problems with the government setting rates drawing upon examples from other countries. Mr. Mahmood felt it would be very difficult for NEPRA to set all rates, and suggested that NEPRA be responsible for establishing a regulated company revenue requirement, with the government responsible initially for rate design and setting rates for particular customer classes.
- Generation is intended to be competitive, but competition will not be effective for some time. Until competition is present, some regulation will be required. Regulation should focus on contracts.
- Rates should be established through "indexation" rather than focusing on the individual company's cost. Regulation of distribution could be an RPI-X system.

- Regulation has to create incentives for expansion; there will probably have to be an "adder" for this purpose if there is an RPI-X regulatory system.
- The regulatory system should be simple, at least at the start.
- Mr. Mahmood is "extremely concerned" about whether the setting of end-user tariffs by an independent agency will work in Pakistan. He believes end-user tariffs should be left to the government.
- The regulatory entity needs a constitutional guarantee.

There was a general agreement that the regulatory authority should represent a "Pakistani" solution and systems that work in other countries are likely to be incompatible with Pakistan's culture, values and government institutions and procedures.

Mr. Hall put two questions to Mr. Mahmood. The first was whether any regulatory authority is required. The second was, if a regulatory entity is necessary, how should such an entity be constituted to make at viable in Pakistan?

Mr. Mahmood first responded by questioning the need for privatisation. Mr. Mahmood doubts that many efficiencies will be achieved through private ownership of existing thermal generation. Pakistan should concentrate instead on encouraging private investment in new generation through BOT and BOO projects. Mr. Mahmood agreed that a regulatory authority will be necessary with privatisation and that the functions outlined in the Team's working paper, with the possible exception of rates, were appropriate. However, Mr. Mahmood does not believe there is sufficient support for the successful operation of the type of regulatory authority contemplated by the Team. Mr. Mahmood advised the Team to keep the regulatory plan simple. Mr. Malik stated that he had ideas about how this might be done. It was agreed that the team would be back in touch with Mr. Mahmood and Mr. Malik to get their suggestions.

July 16, 1992

(1) Meeting with Pakistan Water and Power Development Authority. Lahore, Pakistan.

Attendees: Mumtaz Hamid, Chairman WAPDA
Javid Akbar, Member Power
Malik Ashraf, MD/WPPO

R. Grimshaw
L. Wilson
R. Fitzgibbons
R. Ruff
G. Hall

Of paramount concern to the Chairman is the autonomy of the regulatory authority. The Chairman is very concerned about the government's interest in maintaining control over NEPRA and rates. He strongly believes that the control needs to be predefined and asked how autonomy from political interference is achieved in other countries. Mr. Hall emphasized that it was important that:

- Regulators have fixed terms and cannot be removed except for malfeasance.
- Regulatory authority should be conferred and defined by statute.
- Budget must be protected from political manipulation.

Chairman WAPDA also inquired as to how the private sector can be kept from unduly influencing the regulatory authority. The Team responded that this is generally accomplished through accountability - which can be achieved by having a transparent process for making regulatory decisions. A discussion followed regarding regulatory systems in other countries.

Transparency and accountability can be achieved by having the standards that the regulatory authority must follow set forth clearly in statutes coupled with an opportunity for judicial challenge. This effort will be enhanced by a requirement for the regulatory authority to make its decisions in an open process and through reasoned, written decisions. In addition, only persons of integrity should be appointed to the regulatory commission.

The Chairman raised the issue of rate regulation. He agreed that rates must be approved by the regulatory authority and not the government. A great deal of time was spent talking about the different approaches that have been used for setting rates worldwide. There was a consensus that rate regulation should not be used to pursue social policy goals unrelated to the goals of reflecting accurately the costs of power services and the relative scarcity/abundance of power resources. It was also agreed that rate regulation should be transparent. The Chairman seemed to be impressed with the fact that regulators in other countries specify in great detail the basis for their rate decisions.

The Chairman then turned to the issue of "fast track" privatisation. He was very concerned that the entire privatisation effort could be derailed. The Team expressed its agreement regarding these concerns. MD/WPPO opined that fast track privatisation could exacerbate labour problems. These problems are already significant. In privatisation programs worldwide, labor reductions of 20 to 45 percent are not unexpected, and a reduction of 40 percent for WAPDA is likely, which could translate into the loss of 60,000 jobs.

Also, the credibility of privatisation could be undermined by failure to obtain good value, failure to elicit a significant number of offers, and rapid privatisation can result in a poor industry structure. The Chairman believed that the government needed to understand that good planning will result in credit being given to this government even if the actual sale does not occur until later.

Finally, the Chairman raised the issue of what will remain of WAPDA after privatisation. He is concerned that only the "dirtiest" distribution areas (that is, those that are unprofitable) will remain WAPDA's responsibility. The Team responded that the fact that a distribution area is poor and cannot afford high rates does not mean that it must be unprofitable and unable to be privatised. The Strategic Plan recommended that these poor areas be directly subsidized by the government, and that the private sector is indifferent as to whether it gets its compensation from consumers or from the government.

This led to a general discussion of subsidies and the fact that subsidies are already provided but hidden in WAPDA's tariffs. Privatisation will make it more difficult to hide the subsidies. The Team recognizes that the GOP will have to continue to subsidize various social and economic policies, but believes it is critical to make such subsidies transparent.

(2) Meeting with Planning and Development Board Punjab Province, Lahore, Pakistan

Attendees: Dr. Muhammad Arif,
Additional Secretary
Planning and Development Board
Punjab Province

Charles K. Ebinger
Arun Banskota

Dr. Ebinger began the meeting outlining the goals of the Strategic Plan and the critical objectives and issues affecting the creation of a regulatory regime. Dr. Muhammad Arif than explained that under the Pakistan Constitution provincial governments can buy bulk power and set tariffs, although he believed that only Azad Kashmir was doing so at this time. He stated that WAPDA had nearly complete control over generation and that WAPDA had blocked a small hydel project that Punjab wanted to build, arguing that the project was uneconomic. He explained that while some large industries in Punjab self generate and sell their surplus power to the grid, he did not visualize any active role for provincial governments in generation following privatisation.

The additional Secretary believed strongly that the NEPRA should have independence, be in charge of setting all electric power rates and that the members should be allowed to hire and fire staff. He stated that the constitutional requirement that any profit from hydel power goes to the province in which the generation facility is located is a major stumbling block. This provision will prove to be a major problem for any private company taking over a facility in the absence of a constitutional amendment. Alternatively, the Federal Government can recompense the private company for the amount of its profit paid to the province. The Additional Secretary said that he believes the Federal Government pays the NWFP far too much money under the Indus Water Accord. He acknowledged that there was no likelihood that the formula will be modified owing to political considerations.

Dr. Arif stated that the problems arising from these transfer payments is made more acute by the fact that the provincial governments recoup the fuel adjustment charges arising from their use of thermal back-up power and that this transfer is counted as profit, even though consumers not located within such provinces have paid for the thermal generation used to provide such power.

Dr. Arif was extremely critical of WAPDA. He opined that the organization has been systematically mismanaged, and is plagued by waste, corruption, power theft, and an irresponsible attitude towards maintaining its capital stock especially machinery. He was highly critical of the IBRD and the IMF for never systemically dissecting WAPDA's cost structure. He stated that he believed that attacking WAPDA's cost structure following privatisation could obviate the need for major tariff increases, thereby making the process more transparent and more politically acceptable. He said that he thought interesting areas for investigation were (1) WAPDA's failure to charge interest on accounts in default, (2) inaction regarding theft, and (3) WAPDA's failure to threaten disconnection to those ministries that are always in arrears.

Dr. Arif said he believed a crisis was needed to galvanize the nation to address these problems. He believed that WAPDA is too powerful a buearacray and that it needs to be broken up.

Regarding a proposed regulatory structure for NEPRA, he recommended that all the provinces and Azad Kashmir should be represented. Dr. Arif also suggested that the Chairman should be a highly regarded non-technical person, while the other commissioners should be technical experts. He stated that he thought the NEPRA can be somewhat insulated from political pressures by placing it under the Council of Common Interest, a body designed to reconcile differences among the provinces.

Dr. Arif stated that he thought provincial electrical inspectors were virtually useless and that, while some viewed their jobs responsibly, most were either useless or corrupt.

Finally he advised the Team to talk to (1) provincial power authorities, which while institutionally weak, have strong views on electric power privatisation, and (2) Member Power in WAPDA.

July 18, 1992

(1) Meeting with Faisalabad Area Electricity Board, WAPDA
Lahore Pakistan

Attendees: Mazhar Muhammad Anwar Harral, Chairman
Mr. Malik Ashraf, MD/WPPO

R. Fitzgibbons
L. Wilson
A. Banskota
G. Hall

Mr. Harral asked whether the privatised distribution companies will have development of uneconomic projects as an objective. The Team responded that they will, but that development subsidies will be handled differently. This lead to a general discussion of subsidies.

Mr. Harral said that farmers can not pay the cost of producing their crops. There have been subsidies for fertilizer and other inputs but these have gradually been eliminated except for the subsidy on power. However, price controls on agricultural crops have not been reduced. The result is that farmers are being squeezed and agriculture is barely profitable.

Mr. Harral reported that the feeling in Faisalabad is that with privatisation electricity rates will increase and the GOP will not provide subsidies. He said the public and labor will not "appreciate" privatisation and something will have to be done to overcome the opposition. Mr. Harral recommended that the GOP set forth a clear governmental policy regarding the availability of subsidies in order to avoid agitation against privatisation.

The problem with regard to village electrification is not with the contribution to the capital costs of constructing new lines. The problem is covering the costs of operation and maintenance. The current energy charge does not cover the costs of fuel and O & M.

That is, current rates not cover variable costs. The current rates for tube wells do not even cover the energy costs. He said that the monthly charge for a two horse power motor would be on the order of R 2,500. The energy cost will be approximately R 5,600 per month.

Mr. Harral said that if privatisation is to be successful, public opinion will have to be mobilized and labor's concerns addressed. He discussed his successful experience and the lessons he learned when he was in charge of WAPDA's takeover of the utility that once served Rawalpindi.

Rawalpindi had a bogus balance sheet. Pakistan was under martial law. Using martial law authority, he quelled the unrest that resulted from firing many people. However, that will not be possible today. He said if he tried to fire an assistant lineman at Faisalabad, the fired employee will call on his contacts until some high person in the GOP called Mr. Harral to tell him to revoke the firing. On the basis of his experience at Rawalpindi, Mr. Harral believes the GOP must be clear about the impact of privatisation on tariffs and labor.

Mr. Harral described WAPDA's existing tariffs and the subsidies embedded in such rates. Rates are uniform nationally. There are no time of day rates. There is not even any seasonal differentiation. Mr. Harral thought both types of rates are needed.

Mr. Harral pointed out that private utilities got away with murder before nationalisation. This experience is not to be forgotten.

Mr. Hall asked if establishing a regulatory authority can help privatisation of Faisalabad. Mr. Harral strongly agreed. Indeed, absent creation of NEPRA, he believed there will be a "hue and cry." He emphasized this point several times during the meeting.

There was a long discussion about labor concerns. Mr. Harral was asked his opinion about whether converting employee pension funds into equity in the privatised companies will provide some comfort to labor about privatisation. Mr. Harral replied that improving their chances for economic gain only partially addresses labor's problems. The other problem is job security and labor's desire to avoid having to work hard. Mr. Malik did not believe that NEPRA should be involved in the labor transition.

He said that officers must be distinguished from staff. He believed most WAPDA officers will voluntarily go with a privatised firm. Staff members, however, are a different matter.

Mr. Harral believes there needs to be "golden handshakes" to get rid of staff. He believes that a lot of the underemployed staff will not be willing to go to a privatised firm, but will opt for a "golden handshake" or deputation to the succeeding portions of WAPDA.

There was a discussion of labor crises. WAPDA negotiates with the 150,000 member WAPDA Hydroelectric Labor Union. The head of the Union is also head of the federation of Pakistan labor and is a powerful figure. The labor laws will be important to maintaining control over the situation with labor. The government can prevent labor from striking by declaring a facility or industry an "essential service".

There was a discussion of the provincial electric inspectors. There are eight corresponding to the eight area distribution boards. They: (a) address disputes about WAPDA's billing (b) inspect lines for safety, and (c) certify interior building wiring. With regard to billing disputes, there is a provincial government appeal process, culminating in an appeal to the High Court.

Mr. Harral was asked whether the provinces want to regulate the rates of the private distribution companies. He said that this should be a federal task and he did not foresee objections to placing rate approval authority at the federal level.

(2) Meeting with Punjab Irrigation and Power Department, Lahore.

Attendees: A.H. Zaidi, Lahore
Chief Engineer
Abdul Aziz Chaudhry
Chief Engineer Power

R. Fitzgibbons
L. Wilson
G. Hall
A. Banskota

With respect to the process of privatisation, Mr Zaidi said he perceived no difference of opinion between the Federal and Punjab governments.

There was an extensive discussion as to the role of the provinces with respect to utilities. Mr. Chaudhry emphasized that section 3 of the 1910 Act gives provinces the right to license power plants and distribution companies. WAPDA Act exempts WAPDA from these requirements. Rawalpindi and Multan operated under licenses granted by Punjab until 1972. Mr Chaudhry initially supported provincial licensing of power plants located within the Punjab as provided for by the 1910 Act. However, his position seemed to change during the course of the discussion.

The provinces also hear complaints about billing through the office of the electricity inspectors. In Punjab, these inspectors are part of the Irrigation and Power Department. There are five main offices in the Punjab. More local branch offices and personnel are needed to staff the electricity inspection office.

Messrs. Zaidi and Chaudhry were not disturbed by the suggestion that the rates for the privatised distribution companies will be established at the federal level provided there was adequate ability for Punjab to have its interests represented.

The discussion next turned to how provincial concerns might be reflected at the NEPRA. One approach is to create an advisory committee with provincial representatives. The Punjab officials preferred having direct representation. They proposed that there be seats on the commission for the provinces. Each province can submit a list of three to five qualified people with professional experience. The government will select from the list of nominated candidates. The Commission member from a province will provide a channel to NEPRA for provincial concerns.

Mr. Fitzgibbons went through a list of potential regulatory functions and the Team is opinion about where the responsibility should lie. The results were:

- Safety - Provinces
- Consumer rates - Federal
- Quality of services and consumer complaints - Provinces
- Licensing - Federal with provincial involvement
- Planning - Federal

Messrs. Zaidi and Chaudhry did not object to this statement regarding the division of responsibility. They stated that a national regulatory authority will better assess all of the needs of the nation, concentrate limited technical resources and have greater leverage to address tough issues. However, there statements in this regard controdicted positions they had taken earlier in the meeting. The provinces should be responsible for investigating companies' compliance with their service obligations as set forth in their licenses. If there is a problem, the provincial authorities would bring the matter to the attention of the federal authority for purposes of enforcement and sanctions. The Team was told that there are electrical standards now but that there is no enforcement mechanism. The consensus was that the Federal Government should set standards and the provinces should enforce.

Messrs. Zaidi and Chaudhry supported federal licensing on the basis that there would be more expertise at the federal level and the companies seeking licenses would be better known.

There was a discussion of the need and mechanisms for enforcement. License revocation is a draconian measure, but effective. The discussion concluded that the agency granting licenses should be responsible for revocation.

There was a strong view expressed that resolution of billing disputes should remain a provincial function.

(3) Meeting with Cabinet Committee on Privatization
Cabinet Secretariat, Ministry of Finance
July 18, 1992

Attendees:
Minister of Finance
Minister of Industry
Minister of Irrigation and Power
Chairman WAPDA
Joint Secretary Cabinet
Additional Secretary Cabinet
Additional Finance - Privatization
Secretary Ministry Water and Power
Additional Secretary Ministry of Water and Power
Secretary Finance
Secretary General Finance
Secretary Privatization Commission
Economic Affairs Division Finance

R. Grimshaw — Acting Chief of Party, IRG/ESI
C. Ebinger — IRG

The meeting commenced with Secretary Poonegar introducing Mr. Grimshaw and Dr. Ebinger to the Committee. The Minister of Finance then asked Dr. Ebinger to make a presentation to the Committee highlighting the key features of the Strategic Plan. Following the presentation, a free flowing discussion followed.

The Finance Minister stated that while the government agreed with the concept of vertical disintegration for WAPDA as recommended in the Strategic Plan, there were still important questions that need to be addressed such as: Do you sell all/some plants? What is the best way to restructure management to increase asset value prior to full privatization. The key interest of Pakistan to private investors is the fact that electricity demand is growing 8-10% per annum providing an attractive long term growth market.

Given this fact, the Finance Minister stated that it might be preferable to sell an initial 26% of a facility through a private placement, while simultaneously selling an additional 25% on the Karachi exchange. The remaining 49% would be held by the Government, but with the private placement purchaser being assured that at some point in the future another 25% would be sold thereby ensuring a majority privatised interest while maximizing the governments' revenue. During the process, the private placement purchasers would have complete managerial autonomy allowing the investor to enhance the value of the asset through greater operational efficiency. The Finance Minister stated that the key issue is at what level (price) electricity is sold.

The Finance Minister suggested that Jamshoro could be sold by determining the current cost of generation and adding 20% and then making this a maximum bid price acceptable to the Government. It was not clear if the price should be discounted for projected maintenance or facility upgrading.

Mr. Mahsud stated that there were outstanding labor, tariff and regulatory issues that need to be addressed immediately by the Government. He stated that parliament must be taken into confidence and that the Strategic Plan as amended by the Government should be presented to a joint committee of the parliament as soon as possible. Simultaneously, the President should promulgate an ordinance allowing WAPDA to corporatise Jamshoro. At the same time, legislation should be drafted for formally amending the WAPDA Act and should be submitted to the Parliament for timely approval.

The question was then raised about how to treat projects in the "pipeline" during the transition process. It was agreed that projects under construction would not be privatised. Several cabinet members queried if WAPDA should remain in control of the transmission system. Dr. Ebinger explained that while the transmission system would remain initially under government control, it should be in an independent body and not part of a residual WAPDA generation entity.

There was then a major discussion of some of the critical issues affecting privatisation of the distribution system and how tariffs would be handled by an independent regulatory authority.

The Finance Minister stated that the regulatory regime should be functioning effectively in 18 months, though it would be established by March 1993. He also noted that assuring existing employees that their rights would be protected under privatisation was an essential precondition for success. The Finance Minister stated that a new document on privatisation would be prepared and presented to the Joint Committee of the Senate and National Assembly in August 1992.

Mr. Poonegar explained that distribution companies must not be allowed to abandon unprofitable rural areas and questioned whether subsidies could be paid to privatised area boards as advocated by the Advisory Team.

The Finance Minister stated that while nationalisation of electricity prices was essential, he did not believe it would be possible to eliminate cross subsidies completely and replace them with transparent subsidies paid by the exchequer.

It was agreed that the Privatisation Commission should be responsible for all elements of the privatisation process including the hiring of consultants and that the Secretary, Water and Power should be made a member of the Commission.

It was agreed that two big (Jamshoro and Kot Adu) and three small power plants should be sold as quickly as possible.

Mr. Grimshaw stated that selling shares in a foreign stock exchange usually takes eighteen months. Mr. Mahsud warned that if all four large generation plants were sold at once, it would not be possible to find capital for such a purchase. Dr. Ebinger warned that the privatisation process could be derailed if, as a result of the fast track approach, generation plants were not sold at full value. After detailed discussion, the Cabinet Committee decided:

1. In addition to the Jamshoro and Faisalabad privatisation called for in the Strategic Plan, that the following power stations should be added to the list for fast track privatisation.

   a. The Shahdara Gas turbine Power Station - 85 MW
   b. The Multan Steam Power Station - 130 MW
   c. The Multan (Piran Ghaib) Natural Gas Power Station - 265 MW
   d. The Faisalabad Steam Power Station and Gas Turbine Power Station - (132 MW & 200 MW)
   e. The Kot Adu Gas Turbine Power Station - 1000 MW

The rest of the Strategic Plan was adopted except that the consultants were told to speed up the timetable recommended in the Strategic Plan. In addition, it was determined that the issue of cross-subsidies needed to be examined in greater detail, and that rural electrification and lifeline rates must continue.

2. The Government authorized taking all necessary steps to implement the Strategic Plan, including the enactment of legislation to implement the Strategic Plan.

3. Jamshoro, Kot Adu, the other generation power plants delineated above and Faisalabad will be privatised in the first phase with other units to follow.

4. The Cabinet Committee approved that all necessary amendments in law required for privatisation, including amendment of the WAPDA Act, should be accelerated so as to not delay the timetable for the privatisation process.

5. The terms of transfer of loans, in respect of units offered for rates, should be delineated in the tender document.

6. A new paper for the Joint Committee of the Parliament should be prepared and a presentation on the

privatisation of the power sector be given to the Joint Committee in August 1992.

7. The Secretary, Water and Power should be approved as a Member of the Privatisation Commission (Power Sector).

8. Privatisation of KESC should be further reviewed and the summary on this subject that is now pending before the Cabinet may be withdrawn by the Ministry of Water and Power.

<u>July 19, 1992</u>

(1) Meeting with Irrigation and Power Department, Government of Sindh, Karachi

Attendees: Mr. Mohammad Idris Rajput, Secretary
Irrigation and Power Department

C. Ebinger
G. Hall
R. Fitzgibbons
L. Wilson

The Secretary commenced the meeting by explaining that his office is concerned primarily with irrigation and has only broad oversight of KESC. KESC is responsible for all power generation, transmission and distribution in Karachi and in a small area of Baluchistan. Whatever KESC does requires Sindhi government approval, including tariffs. However KESC is strongly controlled by the Federal government through WAPDA's ownership of a large number of KESC's shares and through the subsidies the federal government provides to KESC and its customers. The Chairman of WAPDA is also the Chairman of KESC.

The Secretary explained that the GOP's uniform national tariff policy severely undercollects for the real cost of power generation. KESC is completely thermal-based and relies on costly oil imports (with the exception of the Candu nuclear reactor). He explained that when the Federal Government raised tariffs 7.7% earlier in the year, the Sindh government initially refused to approve the increase, and raised KESC's tariffs only 2.2 % even though KESC's real costs of providing service had increased in excess of 7.7%. Only on July 7, 1992, after the Federal Government threatened curtailment of all power subsidies, did the Sindh government comply with the rate increases and reestablish tariff uniformity.

Mr. Fitzgibbons then solicited the Secretary's views on the role of the provincial governments in regulating the electricity industry. The Secretary stated that while generation and transmission could be privatised, he personally believed that the private sector had been extremely slow in responding to the government's privatisation initiative and that he did not foresee the completion of the Hab River Project.

The Secretary was extremely skeptical, on political grounds, about whether local distribution could be privatised, especially in an urban area such as Karachi. He explained that corruption is rampant throughout the system, citing both the recent audit report of KESC as well as the ADB's decision to terminate its assistance to KESC pending improvement in the organization vis-a-vis the collection of its receivables. He stated that currently KESC renewables are anywhere from 24-34 months in arrears -- far longer than the period which the ADB has put as a condition of its loan (receivables are to be no more than three months in arrears).

He stated that while the Sindh government officially wants control of KESC, it wants control without any responsibility for KESC's liabilities. The Secretary saw this as a totally unsupportable position. He stated his personal view, contrary to the official Sindh government policy, that the Federal Government should be in control of KESC since Federal subsidies were all that kept the organization afloat.

He said it was important to understand that the Federal Government paid large subsidies to KESC for two primary reasons.

First, to maintain the GOP's policy of uniform electricity tariffs across the nation and, second, to keep KESC economically viable in order to obtain political support in Karachi.

The Secretary said that it was vital for the Team to understand the political/economic pressures under which KESC operates. KESC receives no money from the Water and Sewage Board (WSB), its largest customer. WSB refuses to pay its bills and WSB can not be disconnected for political, social and technical reasons.

The political power of WSB is so great that when KESC tried to raise power rates to the WSB by 25%, a cost which would have raised the water tariff on an acre of land producing R 5000 of production from Rs 25 to R 31, the WSB protested to the Sindh Government and was supported in not paying its electricity bills. The Secretary pointed out that the failure of KESC to improve on its arrears made it dangerously close to violation of World Bank covenants. If the situation continues until 1996 when its loans with the Banks have to be renegotiated, KESC's rates will have to be increased by 200% to come into conformance with Bank covenants.

The Secretary explained that the situation is becoming critical since the Federal Government earlier these year announced it would no longer provide subsidies to KESC. He stated that it was time to address the authority of the labor unions serving KESC. He said the power of the union was so great that union leaders theoretically making R 2,000/month often made more with kickback, payoffs, etc., than the managing director of KESC (who earns a normal salary of Rs. 20-25000/month).

He questioned whether these problems could be solved in the absence of authoritarian rule. As an interim step, he believed that the ownership of KESC should be turned over to WAPDA to apply greater pressure on the government to address KESC's problems. He said the telephone company had the ability to cut off customers if bills were not paid. KESC should be able to do the same and not be held hostage to political blackmail by the WSB and the Sindh government. The Secretary cited the example of the Karachi steel company where authoritarian rule by the military was imposed to bring the company back from financial trouble created by the labor union.

Before the meeting ended, the Team asked whether Secretary Rajput thought the Federal or provincial government should regulate a private distribution company. The Secretary responded that he felt the Federal government should regulate the distribution company for several reasons, including the degree of subsidies provided by the Federal government, the need for federal involvement in regulation to balance the strength of the labor unions, and the fact that the provincial government does not have the resources necessary to engage in the sophisticated task of rate regulation. He emphasized, however, that provincial interests will have to be represented in the decisions of the national regulatory authority. In addition, he opined that it was imperative that a private company needs to be able to collect bills, and that this will not occur if the provincial government remains directly in control.

(2) Meeting with Karachi Electric Supply Corporation (KESC), Karachi, Pakistan

Attendees: Mr. Mazhar Hussain, Managing Director KESC
Mr. B.H. Qureshi, Financial Advisor KESC
Mr. Munir Uddin Siddiqui, Chief Engineer, Bin Qasim Power Station, KESC
Additional KESC Staff

C. Ebinger
G. Hall
R. Fitzgibbons
L. Wilson

Dr. Ebinger opened the meeting highlighting the key features of the Strategic Plan, adopted by the Government on July 18. He explained the functions and objectives of a regulatory regime.

A general discussion then ensued on the implications of the Strategic Plan and NEPRA for KESC. Mr. Hall explained that for the privatisation initiative to be successful, NEPRA must achieve the requisite degree of autonomy. There were three ways this might be done. One way could be through constitutional provisions establishing NEPRA based on the model of the Federal Ombudsman. Alternatively, enabling legislation could be passed for establishing NEPRA's autonomy. Another option would be a presidential ordinance creating NEPRA. Mr. Hall argued forcefully that NEPRA's duties and power must be set forth in law, that the commissioners must have fixed terms and not be subject to removal on grounds other than malfeasance. NEPRA must also have an independent budget to have the requisite degree of autonomy.

The Managing Director than queried who would be responsible for planning future supply/demand requirements. Mr. Fitzgibbons stated that for the most part this would be taken over by the privatised companies. Generation companies would be responsible for meeting their contractual obligations to distribution companies. Distribution companies would project load growth and anticipate system needs and plan accordingly. The transmission company would be required to expand the national grid as necessary to meet the needs of generation and distribution companies.

Mr. Mazhar expressed some concern that the Government could not totally give up its role as the central forecaster of electricity supply and demand given the importance of the sector to the Pakistan economy. While the Advisory Team agreed that the Government might wish to continue the planning function, to a mild degree, in the form of national economic planning, the NEPRA would review the expansion plans and the supply/demand forecasts of the various elements of the privatised electricity system. This view was received with a great deal of skepticism by some of the KESC officials.

The Managing Director stated that while he could see how generation and transmission could be privatised, he had severe doubts concerning the political viability of privatising electricity distribution. He stated that currently the Karachi Water and Sewage Board, KESC's largest customer, refuses to pay its bills, which now amount to R 25 million/month. The KWSB is supported by the Sindh government. The only reason that there has not already been a major crises is that the Federal government has covered KWSB's arrears for political reasons. However, in July the federal government announced that it would no longer provide such subsidies.

He said KESC was in a crises. While the company has a small maintenance reserve margin, it has no spinning reserves. In addition it can not cut off service to the KWSB without both evoking a social political crises in Karachi as well as hurting its own system since it needs water from the KWSB to run some of its generation stations. One member of the KESC delegation said that there would be riots in the streets if electricity were cut off to the KWSB.

A wide ranging discussion then ensued about how tariffs can be set in power pools, how power pools function, and how they might be applicable to a privatised KESC. The discussion then turned to a discussion of KESC's plans to acquire more capacity. The Managing Director said that KESC was negotiating to buy more power both from WAPDA and from Hab River. He said that KESC's options are limited both by the fact that it is not allowed by the GOP to build its own new thermal generation station and by the serious economic situation confronting the company.

The Managing Director stated that while he personally believes that KESC must and should privatise, that the company is getting a host of conflicting advice on how to do this from the ADB, USAID, the IBRD and other bilateral donors. It appeared that KESC has a plan to privatise KESC as a vertically integrated entity by selling shares in transches.

Indeed, several of the KESC staff questioned why the Team had not looked at dividing WAPDA into several vertically integrated utilities. Mr. Fitzgibbons and Dr. Ebinger stated that the Team had indeed considered this option, but that experience in the United States demonstrated that such an approach did not foster competition and that such systems do not encourages IPPs and other actors to enter into the power business. This view was not shared by the KESC representatives.

A KESC representative then queried how you can make NEPRA an autonomous regulatory body free from political interference if the members are picked on the basis of provincial representation. The question was also asked as to what would happen if the government agreed to make direct payments to privatised distribution companies for providing uneconomic services, but then refused to meet its obligation when the bills came due.

The KESC staff expressed skepticism about whether NEPRA would have the authority necessary to stand up to the government. The Team conceded that there were no firm guarantees that it would be able to resist political pressure. However, it seemed to the Team that a combination of sanctions against the government officials refusing such payments (by the federal Ombudsman), the threat of non-compliance with donor agency loans (IBRD, ADB and bilateral donor covenants) and NEPRA enabling legislation (allowing it to appeal in such a situation to the Pakistan Supreme Court) could deter the Government from embarking on such a policy.

<u>July 20, 1992</u>

(1) Meeting with Pakistan State Oil

Attendees: A.S. Qureshi
General Manager (Construction)

C. Ebinger
R. Fitzgibbons
G. Hall

Dr. Ebinger summarized the Strategic Plan and the working paper on regulations Dr. Ebinger stated that the particular topic that brought the Team to PSO was fuel price regulation, and its impacts on inter-fuel competition and investment decisions in power project.

Mr. Qureshi asked a number of questions about IRG, H&W, PHB and the project. He asked about the Cabinet Committee on Energy's approval of the Strategic Plan. Dr. Ebinger stated that the major issue is whether the regulatory authority will approve rates or merely recommend rates to the GOP. This led to a long discussion with Mr. Qureshi on independent agencies and the GOP, thereby providing a very helpful history of governmental relationships within the GOP.

He stated that the nature of the governmental power structure dates back to the British colonial period. Most commissions and agencies are recommendatory bodies. By virtue of its control over the budget, the Ministry of Finance is very influential. Mr. Qureshi made a number of suggestions for achieving an independent regulatory authority.

- o Mr. Qureshi believes it is important that the member(s) of the regulatory authority not be subject to transfer to some undesirable outpost.
- o The board must have members and staff of the highest professional qualifications. He believes this requirement should be written into statute.
- o The regulatory authority should establish its own staffing levels. The compensation levels for staff and the board members should be substantially in excess of civil service levels.
- o There should be independent funding. The authority must be self financed and the Chairman should take the authority's budget directly to the Cabinet or parliament without going through the normal budgetary process. The budget process and ability to be self funded should be written into the enabling statute.
- o Accountability should be engendered through parliament's review of the authority's budget and through audits conducted periodically by the Auditor General to be submitted to the Public Accounts Committee of Parliament.

The discussion next turned to the selection of the Members of the regulatory authority. Mr. Qureshi was opposed to having different seats designated to provincial representatives. This would lead to uneven representation of the provinces. Instead, he recommended either advisory committees or empowering the Commission to solicit the views of the provincial governments on matters that affect their interests.

Mr. Qureshi believes that there should be no appeal from the authority's decisions except for matters of fraud and abuse. He believes that there should be time limits set for regulatory decisions. Otherwise, he said you will never have a decision rendered.

Dr. Ebinger raised the question of subsidies. What can be done to encourage the GOP to pay its bills. Mr. Qureshi replied by citing the example of Pakistani International Airlines. Apparently, the armed forces and their families travel at half fare. The army pays PIA the other half from the defence budget. PIA has in fact threatened to terminate service for the Army's failure to pay. By analogy, the agricultural ministry could pay for tube wells from its budget.

Mr. Qureshi emphasized the need for tariffs that collect monies for asset replacement. This has not been done with respect to the regulated oil rates. There has been no new investment in oil refining or distribution since 1962 when oil prices were first controlled.

Dr. Ebinger asked about inter-fuel competition. Mr. Qureshi said that oil prices were controlled but the consumer was paying an implicit price in the form of low quality service. There is a negative profit margin of 16-81% on the sale of residual fuel oil.

Mr. Qureshi was asked if the NEPRA should have responsibility for oil-price regulation. He said no because the two areas involved a different set of issues.

(2) Meeting with NWFP Government Secretariat
Peshawar

Attendees: Khalid Aziz, Additional Chief Secretary
Abdul Wadood, Project Manager, Small Hydro
Amjad Afridi, Chief, Water & Power
Dieter Schulken-Grossmann, Resident Engineer, GTZ
B. Grimshaw, IRG
A. Banskota, IRG

The Provincial Government had severe problems with the Federal Government regarding the lack of information and interaction on many issues, of vital interest to the Provinces, such as telecommunications and education. The Additional Secretary complained that the Provinces were being treated similarly on the privatization issue as well.

Of critical importance, Mr. Aziz felt that for electric power privatization to be official GOP policy, it had to be approved by the National Economic Council (NEC). The NEC, according to the Constitution, approves all major changes in policy, and the view of the NWFP Government was that privatisation of the electric power sector was of such vital importance.

Some other issues that are relevant include:

- Hydel Profits. Mr. Aziz felt that the Strategic Plan had not clarified GOP position on hydel profits. The dispensation of net profits has not been done according to agreed upon formula.
- Pace of Privatization. The consensus among the officials present was that the pace of privatization recommended by the Strategic Plan was too ambitious. The Team pointed out the GOP's mandate and that we had attempted in all cases to try to bring realism into the proposed time-frame. However, the officials clarified that corporatisation is a good move, and that we should not wait to take that step.

- Provincial Ownership of Generation and Distribution Companies. The NWFP Government is considering investing in a 600 MW hydel project. The officials wanted to know the implications of the NEPRA on provincial ownership. Under the Constitution, provinces are able to own generating and distribution companies. This issue should be dealt with in the NEPRA Report.

- Provincial Claim on Assets. WAPDA had taken over certain assets that were owned by the provinces. For example, Dargai (25 MW hydel) and Jabban (approx. 20 MW hydel) were NWFP assets that were taken over by WAPDA when it was set up. If WAPDA is being privatized, then the NWFP believes it has a legitimate claim to these assets, instead of such assets being sold to private investors.

The meeting ended on a very friendly note. The NWFP officials were glad that the Team had taken the time to take their views into consideration, and they were quick to explain that their problems were with the way the Federal Government handled issues with the provinces, and that this had affected their views on the electric power privatization issue as well.

July 21, 1992

Meeting with USAID Islamabad

Attendees: Randall C. Cummings, Acting Chief, Office of Private Enterprise and Energy.
Mian Shahid
Jack Swift
Ken Lussier

C. Ebinger
R. Grimshaw

The meeting commenced with a discussion of Mr. Masud's briefing to AID on IRG's presentation to the Cabinet Council on Energy. Mr. Masud was pleased by the meeting which endorsed the Strategic Plan with the slight modification that additional plants should be corporatised/privatised simultaneously with Jamshoro.

Mr. Masud also highlighted the need to move as rapidly as possible on Faisalabad. AID stated that the million dollars which had originally been allocated for Faisalabad could be used for that purpose.

Mr. Cummings voiced concern about whether some of the smaller plants now proposed for sale are not integral to WAPDA's operation, e.g. voltage, maintenance etc. He asked whether this issue had been examined. Mr. Grimshaw said he would take the matter up with the MD WPPO.

Mr. Grimshaw reported that at the Cabinet meeting Mr. Masud had stated that he envisaged a small organizational structure for NEPRA, comprising a financial and legal advisor and that the WPPO and foreign consultants could be used as technical staff. Dr. Ebinger stated that it was essential to integrate the Advisory Team's recommendations for NEPRA with Mr. Masud's view.

Mr. Swift then asked about the Team's proposed organizational structure of NEPRA. Dr. Ebinger stated that, if it were politically feasible, the Team believed that it would be preferable to make NEPRA directly responsible to the Parliament by passing any particular Federal Ministry. Mr. Grimshaw and Dr. Ebinger then highlighted the discussions they had had with provincial governments. They stated that they believed that major involvements by these governments had to occur to ensure the success of the privatisation initiative.

Mr. Grimshaw noted that in his discussions with the NWFP authorities, that they had expressed concern about the speed of the privatization process and stated that they had never received a copy of the Strategic Plan from the Federal Government. Mr. Grimshaw noted that the NWFP also had a water and power authority, preexisting the creation of WAPDA, which had transferred provincial facilities to WAPDA. According to NWFP authorities, if these plants were privatised, the NWFP government wanted them back to ensure that the province benefitted from the sale of the assets and that the privatisation process occurred in a manner consistent with the concerns of the NWFP. The Secretary cited the constitutional provision giving the NWFP such authority.

Dr. Ebinger then highlighted his discussions with the Sind governments stating that the Sindhis under the 1910 Electricity Act believed they had the right to play a major role in setting electricity tariffs. Both the North West Frontier and Sindh provinces are generally supportive of the privatization process but want to be more activity involved in governmental decisions-making on these important issues.

The discussion then turned to whether provincial governments under the Strategic Plan had the right to build small scale hydro plants either by themselves and/or in partnership with private developers. Clearly, the view of the provincial government is that they have this right and that they also have the right under the 1910 Act to be involved in setting tariffs.

A free flowing discussion then focused on the following issues: the organizational structure of NEPRA, the level and method of compensation for the commissioners, the timing of future NEPRA, privatisation activities, etc.

(2) Meeting with Energy Planning and Development Project

Masood A. Malik
General Energy Advisor
USAID/Energy Wing

A. Banskota
G. Hall
A. Doernburg

This was a continuation of the earlier meeting with the Energy Wing. Mr. Malik went over in more detail topics covered at the earlier meeting.

Mr. Hall begin the discussion by emphasising that the Team did not seek to bring a US, UK or any other predetermined solution to Pakistan. Rather, the Team seeks a Pakistani solution and Mr. Malik's help to that end was solicited.

Mr. Malik questions the wisdom of privatization. However, he agreed that this issue is behind us as a result of the Cabinet Committee's approval of the Strategic Plan.

Mr. Malik said that the Working Paper No. 1 on regulation might be a good document for projecting a regulatory scheme for 50 years from now. However, it was not a good document for defining the immediate steps that need to be taken. To address this issue, he asked why regulation was needed. With respect to producers, BOO/BOT or producers in a competitive market, it was agreed that little or no regulation is required. Mr. Malik was of the belief that because of the slow speed of Pakistani Courts, it might be desirable if the regulatory authority could exercise a contract-dispute resolution function. He was not convinced, however, that the authority could be effective in this area. How contract disputes might be adjudicated by the NEPRA was discussed.

Mr. Malik believes planning and forecasting should not come under the new authority. These functions should be left were they are now. He did see a role for the NEPRA in promoting and advancing the privatisation process.

Mr. Malik sees the regulatory authority's function as limited to oversight of privatised distribution companies. However, he believes the regulatory authority should get involved in the privatization process early, at the corporatization stage, and help prepare for privatisation.

He believes the key issue is the cost of service of distributors. He discussed the work of EBASCO and AEP on the valuation of WAPDA assets and developing a cost of service figure.

He proposed an interesting scheme for privatisation of the area boards, assuming a decision made to use an RPI-X type of regulation. He would have the GOP value the assets and say that it would allow some specified rate of return on the assets. Rates to recover the revenue requirement would be allowed subject to a price inflation adjustment. Then, all prospective licences would be asked to submit firm bids for the X factor, the productivity deduction for rates, that they would require. The bidder offering the highest value for would be awarded the license.

Mr. Malik strongly argued the case, made at the prior meeting, that the regulatory authority should only fix the revenue requirement of distribution and not set rates. Rates should be set by the Cabinet. He argued that rates were too politically sensitive to be given to an independent authority.

He believes that if an RPI-X system is used the existing rate structure should be frozen. Mr. Hall asked if this would not perpetrate the current allocative inefficiencies. He agreed, but said that an RPI-X regulatory system would allow for productive efficiency improvement and this was enough of a goal.

Mr. Malik closed by summarizing his main points. These are:

- Focus on next five years;

- Focus on corporatisation and getting ready for privatisation;
- The new authority ought to be burdened with as few responsibilities as possible. Only absolutely essential functions should be assigned to it.

He emphasized that a lot of baggage should not be put on the regulatory authority. Organization building in Pakistan is a slow process. The Energy Wing was established seven years ago and it took five years to get going. The Privatization Cell took three years to get going, and there are relatively few GOP employees.

(3) Meeting with Corporate Law Authority
Islamabad

Attendees: Mr. Khalid Masood, Member Corporate
Mr. Ayub Qureshi, Chief Securities Wing
Mr. Naveed Akhtar, Balocuh Akhtar Associates
Mr. H.N. Akhtar

R. Fitzgibbons

Messrs Balouch and Akhtar, consultants to the Corporate Law Authority, joined the discussions. Mr. Akhtar was involved in the creation of the CLA. Mr. Balouch worked with PIA when the Civil Aviation Authority was established.

The discussion began with a discussion of the division of responsibilities among the members of the CLA. Apparently, although not required by statute, the members have divided up the substantive areas of the CLA among themselves. The individual members act as the Commission in these areas and have the authority to make decisions without having to consult with the other members.

If challenged, the decision of the individual member can be appealed to the Chairman (with the attendance of the challenged member) and, eventually, the High Court. Mr. Khalid explained that if some matter were a "policy" issue, he would have the full commission consider it. The order dividing up the responsibilities among the members is attached.

The CLA also has a very professional staff. Each member is responsible for a wing, with the wing divided up into cells that are each responsible for a specific substantive area. The CLA is modeled after the U.S. Securities and Exchange Commission. In other words, the CLA is organized by function with expertise being made available to each wing. There is no general counsel office. Instead, each wing has an office of lawyers who are responsible for certain substantive areas and providing advice to other cells within their wing.

The staff is delegated authority to make decisions in certain areas. For example, the cell responsible for approving incorporation of new companies is able to approve and disapprove of applications on its own without the involvement of the member responsible for that substantive area. If it involves a policy decision, the matter will be brought to the member's attention. Staff action can be appealed to the member. Delegation of authority has been made easy to implement by incorporating model Articles of Incorporation into the law.

The discussion then turned to the possibility of overlapping jurisduction between the CLA and NEPRA. The hypothetical addressed was the possibility that NEPRA would license participation in the power sector; while the CLA approves incorporation of such companies. Mr. Khalid did not feel that this should be a problem. He said it is analogous to the situation that already exists between the Ministry of Finance with the licensing of investment bank. The Ministry of Finance first issues the license. The CLA then evaluates the Articles of Incorporation, but in large part the evaluation uses the criteria adopted by the GOP entity with the functional area of responsibility.

The key is cooperation between the CLA and the other GOP entity. The attendees advised that this could be encouraged by a requirement of simultaneous licensing and incorporation.

The issue of NEPRA being an autonomous body was again discussed. All agreed that it must be in a autonomous entity along the model of the Civil Aviation Authority. NEPRA must have control over several matters including (1) budget (2) staff selection; and (3) salaries of staff. To enhance autonomy it was also agreed that (1) duties of NEPRA should be fixed by statute, (2) members' qualifications should be pre-specified by statute; and (3) members' position should be tenured and of fixed duration.

In addition Messrs. Khalid and Akhtar suggested that the NEPRA report to a Board of Ministers (comparable to a Board of Directors) as does the Civil Aviation Authority. This Board would review and approve budgets and the salaries of the NEPRA Members. It thought that such a Board would enhance accountability while also minimizing the possibility of political interference.

July 22, 1992

Meeting with Rawalpindi Chamber of Commerce & Industry

Attendees: Najam-ul-Haq Mahir
President
8 members

R. Fitzgibbons
G. Hall

Mr. Fitzgibbons outlined the Strategic Plan and the proposed regulatory scheme. There were a number of questions about how distribution, customers and power generators will interact.

With respect to regulation, the situations of the Sui Northern and Sui Southern Natural gas pipelines and the Civil Aviation Authority were cited. There was agreement that there should be an autonomous regulatory entity with power to approve rates, not merely able to present recomendations to the cabinet. One Chamber member made the point that the rates fixed should be ceiling rates subject to discount by means of negotiation between the distribution company and customer.

Until relatively recently, Rawalpindi was served by a private electric utility. Some argued that the former private company was superior to WAPDA because, if customers complained to the private company, action was taken while WAPDA ignores the complaints of industrial customers. The main problem with the private company, according to the group, was that the private firm did not improve its lines nor did it replace its depreciated assets. While this was being discussed, there was a WAPDA power failure.

The overwhelming and passionate concern of the group was with the quality of service. One manufacturer of control equipment stated that he had purchased four diesel generators because WAPDA's voltage fluctuations damaged his electronic equipment. Even so , he said, hardly a month goes by without damage to an expensive peace of equipment owing to problems with the qualities of WAPDA'selectrical service.

Other Chamber members also told "horror stories". One manufacturer said WAPDA will only provide power for two shifts. At 2:00 each day a WAPDA employee physically pulls a plug on his plant. The group was extremely desirous that WAPDA provide service on a three-shift-a-day basis.

The statement was made that WAPDA has no ethics. By this the group seemed to mean that they had no access to WAPDA and no ability to discuss their complaints.

There was discussion of how the regulatory authority should be constituted. Mr. Aman Ullah Khan, head of the Islamabad Stock

Exchange, argued that there should be political representation on the authority and also representatives of the industrial, agriculture and other communities affected by rate decisions. Mr. Khan disagreed with a statement that such a regime would require a board that would be too large to be workable. He stated that the authority should have 15 or 17 members. He strongly argued that an advisory committee would not be adequate to represent the interests of affected interest groups. In his view, affected interest groups had to be part of the decision making process.

There was discussion of the National Engineering Council. This organization regulates the engineering profession.

There was a general agreement that provision had to be made for rural electrification and other unprofitable activities. The group favoured direct subsidies.

The group agreed that it:

- Is concerned about the quality of electrical service
- Protection of consumers from monopoly distribution companies is essential.

SUMMARY OF PRELIMINARY CONCLUSIONS

ON RECOMMENDED FEATURES FOR A PAKISTANI ELECTRIC

POWER REGULATORY SYSTEM

I. STRUCTURE OF A REGULATORY AUTHORITY

1. Pakistan needs to create a regulatory authority in connection with privatisation of the electric power sector. This authority should be a board with at least five members. Qualifications of the members should be specified by statute.
2. The desirable characteristics of a regulatory authority, (not necessarily in order of importance) are:

   - Compatability with Pakistani institutions, procedures and cultural values. The NEPRA must be a Pakistani solution to the problem of regulatory oversight of monopoly power in a private electric power industry.

   - Simplicity. Economic regulation of a privatized electric power industry will be a new phenomena in Pakistan. The level of technical expertise and experience in the relevant areas is relatively low. It is essential that the mechanisms of the regulatory arrangements adopted be understandable and workable.

   - Limited Scope. There is a danger in all regulatory situations that the regulator will intervene in decisions that should be the province of the private sector. If such governmental interference were to occur in Pakistan, the result would be to undermine the advantages of privatisation and to renationalise the power industry under the guise of regulation. In particular, the authority of the regulator over contracts must be strictly defined. More generally, the boundaries between the scope of authority of the regulatory and the scope of authority of the private entrepreneurs must be defined and observed.

- Autonomy and independence. A viable long term industry in which investors can earn a fair rate of return on capital requires effective and efficient economic regulation. The regulator will be charged with balancing the interests of the private companies and consumers. Effective regulation can only occur if the regulatory authority is insulated from political pressure so that a rational balance can be stuck between the desirability of low prices and the need for fair returns to invested capital.

- Protection against profitering. For privatization to achieve creditability, the public must be provided assurance that monopolies will not be able to enrich themselves unjustly at the expense of consumers. At the same time regulation must protect the legitimate interests and rights of the businesses being regulated.

- Incentives for efficiency and investment. There is a priority need to improve the productive efficiency of the industry, to motivate further investment, and to send price signals to consumers that will encourage voluntary conversation and load shifting. These essentials should be reflected in regulatory decisions and policies.

3. The regulatory authority should be a Federal body, but it is essential to have strong, effective provincial involvement. How to achieve this is a difficult decision. Some or all of the following could be used:
   - An advisory committee with provincial representation.
   - Designated "seats" for provincial representatives on NEPRA.
   - Participation of provincial officials as witnesses in proceedings affecting local companies or local interests.
4. Not all regulatory tasks can or should be performed at the Federal level. The following division of responsibilities should be explored:

   - Safety
   - Rates
   - Licenses
   - Quality of service and consumer complaints
   - Enforcement
   - Planning
5. The authority should be an independent, autonomous agency. This will be extremely difficult, but not impossible, to achieve in the Pakistan context. Absolutely essential requirements for autonomy are:

   - A law expressly setting forth the powers, responsibilities and authority of NEPRA.

Establishment of NEPRA pursuant to a decree would be unacceptable.

- Fixed terms for the member(s) of the authority with protection against geographic reassignment or other retribution for unpopular decisions.
- Legal authorization for the authority to establish its own budget and to present it directly to parliament (or the cabinet) without having to go through the Finance Ministry or any other Ministry or department. NEPRA should be self financing and have the a legal right to levy fees on the entities it regulates to recover its budget.

- The ability to hire, fire and promote staff. This authority should include the ability to establish salaries at rates in excess of civil service schedules.

6. There must be "accountability" and effective oversight of the authority's program. This can be achieved as follows:

- Responsibilities and authority of NEPRA will be precisely determined by statute.
- The budget will be presented directly to and will be reviewed by parliament.
- The accounts of the authority will be audited by the Auditor General of Pakistan.
- The Auditor General's audit will go to the Public Accounts Committee of the Assembly.
- The Ombudsman has authority to review complaints about the regulatory authority.

- The basis for NEPRA's decisions will be detailed in writing and subject to judicial challenge.

7. The members of the authority should have high personal and professional qualifications and relevant training and experience. These requirements should be set forth in the enabling legislation. The members should not just be "judges" or political figures but should take an active part in the authority's program.

8. There could be a division of functional responsibilities among the members. The NEPRA staff could be organised along key functional lines, with the heads of each technical division reporting to a member who would be assigned substantive responsibility by the Chairman.

9. Not all regulatory functions that need to be performed, should be preferred by NEPRA. There are already preexisting by GOP institutions that can assume regulatory responsibilities, e.g. the Corporate Law Authority should be responsible of approving security issuances by NEPRA licensees in consultation with NEPRA. Further, the provinces should exercise certain regulatory functions.

II. ACTIVITIES OF THE REGULATORY AUTHORITY

1. NEPRA activities should be limited to the electric power sector.
2. Ultimately, generating companies should not be regulated with respect to prices or investments, except for obtaining licenses to enter into the power

production business. Initially, rate regulation should be limited to approving contracts between generators and distribution companies. Power projects should not be licensed (although environmental permits will have to be obtained). Regulatory oversight of generators should be absolutely minimal. However, with respect to generation companies, the regulatory authority should:

- License producers
- Review the initial contracts
- Institute enforcement action, if necessary, to enforce contracts during their duration

3. It may be desirable to assign the authority a dispute resolution role because Pakistani courts are very slow.

4. A high priority task of the regulatory authority should be to oversee and promote the development of competitive electric markets in Pakistan. However, the basic responsibility for privatisation should be with GOP agencies other than NEPRA.

5. Transmission rates and pooling arrangement will need to be regulated by the authority and it grant the franchise.

6. There is general agreement that subsidies for nonprofitable activities such as rural electrification, tube wells etc., should be transparent and paid by appropriations in appropriate departmental budgets. There should be no cross-subsidies of unprofitable social activities by means of electricity rates. Overseeing the subsidy program should be a function of

the regulatory authority. In addition the NEPRA should support termination of service for customers who fail to pay their bills, including governmental entities.

7. The regulatory authority should issue licenses to distribution companies, define service franchises, and approve rates. This will involve:

- Licensing
- Rate Regulation; the Team believes the authority should have the power to approve rates but many within the GOP believe the authority's power should be limited to recommending rates to the Cabinet.
- Setting quality-of-services standards
- Monitoring compliance (though primary responsibility for monitoring safety and service should be with the provincial responsibility)
- Instituting enforcement actions

8. Any regulatory price setting methodology in Pakistan must be simple and easy for the public and electric power industry to understand. It should be transparent and easy to apply. These requirements suggests a "light-handed" regulatory approach. Rate decisions should be explained in detail so that all interested parties can understand the technical basis for the rates.

9. Pakistan needs new electric standards (codes) and better enforcement of standards. There is a strong desire that the regulatory authority take on this responsibility, but to do so would burden NEPRA with a

job that could be done elsewhere within the GOP. This issue needs further study.

10. Environmental responsibility can be assigned to the Pakistan Environmental Protection Agency. However, the limited powers and capabilities of that office have engenered a strong view within Pakistan that it would be preferable to assign this responsibility to NEPRA.

11. The provinces currently have electrical inspectors offices that inspect wires, in-house facilities and deal with WAPDA's consumers' complaint. These functions should remain with the provinces but the offices should be strengthened.

12. Planning and forecasting will primarily be the responsibility of the private sector. National planning and forecasting, to the extent necessary, should be done by the Ministry of Water and Power or some other governmental entity.

III **MAJOR POLICY ISSUES**

1. The two major obstacles to privatization are:

- Consumers fear increasing prices as a consequence of privatization. Establishing a regulatory authority will address, to some degree, this fear and a regulatory authority is, therefore, essential to the success of the privatization programme
- Labour is concerned about job security and work standards. While labour issues are not a direct regulatory concern, they have implications for regulation. The labour agreements prior to privatization and the amount of "dead wood" inherited

by the privatized firms will determine how much potential efficiency improvement should be reflected in rates. Inefficiency created by the need to continue current employment levels or to reduce such levels gradually could be paid for by high electric rates but the better method would be by direct government income transfer payments and the Team recommends this approach.

2. A key, indeed absolutely critical, policy issue is whether with respect to the prices of the distribution companies for its services, the regulatory authority should have the authority to approve rates or merely recommend rates to the GOP. There is a strong view within the GOP that the regulatory authority's power should be limited to recommending rate charges to the Cabinet. The Team is absolutely convinced that the regulatory authority should be the sole entity responsible for establishing rates.