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FEASIBILITY STUDY FOR THE PRIVATIZATION OF THE KARACHI ELECTRIC SUPPLY CORPORATION (KESC) THROUGH A PUBLIC SHARE OFFERING

FINAL

March 25, 1992

FEASIBILITY STUDY FOR THE PRIVATIZATION OF THE KARACHI ELECTRIC SUPPLY CORPORATION (KESC) THROUGH A PUBLIC SHARE OFFERING

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Price Waterhouse

March 24, 1992

Mr. Mian Shahid Ahmed
Project Officer, O/PEN
USAID/Pakistan
Islamabad, Pakistan

Re: Feasibility Study For the Privatization of the Karachi Electric Supply Corporation (KESC)

Dear Mr. Ahmed:

We are pleased to present our final report on our study of the feasibility of privatizing the Karachi Electric Supply Corporation (KESC). Our team has enjoyed working on this assignment and hope that our report will be useful to USAID and the Government of Pakistan in improving the overall performance of KESC and enhancing the development of the power subsector in Pakistan.

We have carefully reviewed the comments provided by USAID and have incorporated your recommended changes. We appreciate this opportunity to be of service to you on this important assignment. Please feel free to contact me if you have any questions at (202) 296-0800.

Sincerely

K Rahbani

Kami Rahbani

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I. EXECUTIVE SUMMARY

A. Introduction

1. Background

As part of its overall plan for the expansion of the energy sector to meet increasing demands for commercial energy, the Government of Pakistan (GOP) has established several initiatives to increase the overall efficiency and profitability of the sector. These initiatives have included steps to increase the self-sufficiency of public entities and to increase private sector participation in sector development through the promotion of private power projects.

In keeping with its drive to increase the efficiency of the sector and generate the funds necessary to finance the investment programs of public entities, the GOP has focused its attention on the operations of the Karachi Electric Supply Corporation (KESC) which provides electricity under a License to the Karachi Metropolitan area and other surrounding areas in the provinces of Sindh and Baluchistan. Founded in 1913 as a public, limited liability company, KESC changed hands in 1952 when the GOP purchased 51% of its shares. Since then, the GOP has increased its ownership stake in the company to approximately 93% through increases in the paid-up capital of the company. This shareholding is primarily in the hands of four GOP institutions: the State Life Insurance Corporation of Pakistan (30.6%), the Investment Corporation of Pakistan (28.4%), the National Investment Trust (23.1%), and United Bank (5.8%) who together account for 87.9%. The other 5.1% is held by GOP entities such as the Habib and Muslim Commercial Banks, the Office of the President of Pakistan and similar entities. The remaining 7% not held by GOP entities is distributed among some 5,700 individual shareholders and a few private institutions.

At the present time, KESC's operations consist of a 1723 MW installed electric generating capacity as well as a distribution and transmission system that serves over 8 million people.[1] In addition to its own generating capacity, the company purchases power from the Water and Power Development Authority (WAPDA) as well as Pak Steel. Excess power, when it is available, is also sold to these two entities.

2. Financial performance

Although KESC has recorded profits over the last decade, the company is currently experiencing severe problems that threaten its future profitability. Because its current operating costs are higher than those of WAPDA, which serves the rest of the country, and because the GOP requires that a uniform tariff be maintained in Pakistan, KESC received subsidies from the GOP of approximately Rs. 1,399.70 million for FY 1990/91. Without

[1]KESC Presentation of Secretary Poonegar, 1991. Prepared by KESC Management Studies Department. Figures are as of November 30, 1991.

these subsidies it is estimated that during this period, KESC would have recorded a loss of Rs. 927.15 million. Furthermore, the company is restricted by agreements with the Asian Development Bank (ADB), the principal donor agency to the energy sector in Pakistan, from paying cash dividends until subsidies are eliminated.

In addition, the ADB has suspended KESC's funding because of KESC's current accounts receivable position. As of September 1990, the company had receivables outstanding from the public sector (federal, provincial and local governments) of an average of 10.8 months with some of the local government agencies having accounts outstanding for as long as 21 months.

Although the financial information on which the company's recorded profits are based is audited by external auditors and is readily available and easy accessible, some of the underlying accounting principles on which this information is based are inconsistent with internationally accepted accounting principles. This has the potential of reducing the quality and reliability of the information provided and any financial analysis using this information would raise concerns among potential investors. This is especially true of the treatment of fixed assets fundamental to the conduct of company valuations and the company's deferred tax liability.

3. Management and employment

The participation of the GOP in the management of the company has created a highly politicized management structure and labor force, which in turn has severely limited the successful operation of the company. The presence of the Management Agency arrangement has weakened KESC's Board of Directors and promoted a lack of discipline in the workforce and decisive action in operating the company, more precisely, in the collection of outstanding debts.

B. Objective and Scope

In an effort to improve the performance of the company through increased private sector participation, increase the quality of service to consumers and promote the development of the local capital markets, the Ministry of Water and Power (the Ministry) began to consider the quick sale of between 13% and 18% of the GOP's shareholdings in the company to the general public.

At the request of the Ministry, USAID/Pakistan invited a team of consultants from Price Waterhouse (PW), assisted by a consultant from International Resources Group (IRG) to visit Pakistan for the purpose of providing the GOP with technical assistance in evaluating the feasibility of conducting such a share offering. Specifically, the team was asked to:

- Identify and analyze potential structures for a share offering in response to GOP's objectives. This analysis should include such issues as the impact of a

sale on the share price, the determination of an appropriate price and whether the quality of financial information currently available would be sufficient to conduct the necessary financial analysis for the share offering as well as a strategy for the actual conduct of the offering.

- Develop detailed recommendations on the implementation of the strategy most likely to be successful; and

- Develop the terms of reference for a full privatization study of the company.

Based on a series of meetings conducted with representatives of the GOP, USAID/Pakistan, the Karachi Stock Exchange, commercial and investment banks and brokerage houses as well as senior managers and staff of KESC and reviews of documents, studies, legislation and other relevant materials, the team analyzed the capacity of the market in Pakistan, tested investor perceptions of the KESC share, identified potential obstacles to the success of the share offering and analyzed their impacts on the success of the transaction, developed recommendations for the reduction of these impacts and identified and analyzed five possible structures for a KESC share offering.

C. Conclusions and Recommendations

The determination of the success of a share offering is often made on the basis that all of the offering is purchased or oversubscribed, the price of the share is not perceived as a "giveaway" and there are a large number of successful applicants. In addition, the price of a share offering is based on fundamental factors which affect the future profitability of the company and technical factors which relate to the state of market.

Based on the analyses and interviews conducted during the assignment, an overall conclusion was reached that the GOP had to address several issues before considering the placement of KESC shares on the market. These are:

- Resuming ADB funding

- Restoring KESC's ability to pay cash dividends

- Allowing adequate rates or in some other way replacing the subsidies which are to be discontinued

- Resolving the issue of uncollected receivables

- Resolving the claim against KESC for octroi and land rent

- Extending the period within which the local and provincial governments can exercise the option under the Electricity Act to purchase KESC's undertaking

- Establishing a satisfactory ratemaking process
- Utilizing more acceptable accounting principles in the preparation of the financial statements
- Shifting management control to the private sector to "de-politicize" the current management of the company and send a "signal" to the market that the GOP does intend to remove itself from the management of the company; and
- Protecting the ability of the GOP to implement its overall strategy for the development of the sector, especially in relation to other privatization activities occurring in the WAPDA system.

In addition five possible structures of a KESC share offering were identified and examined on the basis of the criteria described above. These are:

1. <u>The sale of KESC shares to the market through brokers</u>

This strategy has the potential of depressing the market price. There would be no promise of a shift in management control and no correction of the problems currently being experienced by the company, market acceptance would be lower and the price of the share would fall if it became known that the GOP was substantially increasing the supply of shares to the market in an unstructured manner.

2. <u>The sale of KESC minority shareholding to the general public</u>

The use of this strategy would still permit the GOP to hold controlling interest and therefore current management control and the weaknesses associated with it would not be addressed. This would result in a discounted share price as a shift in control would not occur.

3. <u>A private placement to transfer management control followed by a share offer to the general public</u>

This strategy is very similar to the strategy currently being utilized in the privatization of the Muslim Commercial Bank (MCB). This strategy includes the effective shift of management control to the private sector, increasing the possibilities of introducing significant changes in the company and improving its profitability and therefore the price of the subsequent share offer to the public at large.

4. <u>The sale of a large offer to the general public without a private placement</u>

This strategy would only be successful if the offer was sufficiently large to allow management control to be obtained through purchases in the after-market. Such an offer

must be sufficient to reduce the GOP holdings to less than 25%. If this structure was adopted, the GOP could price the offering above current market price. Since the market could not absorb such a large offer, the shares would have to be sold on an installment basis. The CLA has stated that an installment payment method would not be approved.

5. **The sale of a large offer simultaneously with a private placement to financial institutions**

Under this strategy the GOP would not be in the position of choosing the management group as this would effectively be done by the financial insiitutions, thus removing potential allegations of a lack of transparency. The prospects for a shift in management control are strong and the financial viability of the company could therefore be improved. Furthermore, the distribution of shares to a large number of applicants is also achieved and the opportunity to price the offer above the current market price is excellent. The CLA is uneasy about the possibility that no clear management group may emerge.

Although in principle we are inclined to most favor alternatives 4 and 5, we feel as a practical matter, given the concerns of the CLA, that the structure described in 3 (the MCB model) should be pursued by the GOP.

The following exhibit contains a matrix assessing the structures against the success factors described previously.

Structure/Success Factor	Likelihood of full take up	Acceptable Price	Wide Distri-bution	Mgmt Control Shift
1. Sale of Shares through Brokers	Yes	No	No	No
2. Sale of Minority Shareholding to General Public by Prospectus	Yes	No	Yes	No
3. Private Placement and Transfer of Mgmt Control, Followed by Public Offer (MCB Model)	Yes	Yes	Yes	Yes
4. Sale of Large Offer to the General Public	Yes	No[2]	Yes	Yes
5. Sale of Large Offer Simultaneously with Private Placement	Yes	Yes	Yes	Yes

[2]This would be a "Yes" if installment payments were permitted but the Corporate Law Authority (CLA) has objections to this strategy.

II. INTRODUCTION

A. Background

1. Energy sector in Pakistan

a. Current structure

Responsibility for Pakistan's electricity supply lies with the Water and Power Development Authority (WAPDA), a Government-owned statutory body, and the Karachi Electric Supply Corporation (KESC), a predominantly Government-controlled, public limited liability company. Both institutions provide transmission, generation and distribution of power in their respective areas, and are subject to the administrative control of the Ministry of Water and Power. Additional generation is provided by the Government-owned nuclear station at KANUPP. KESC's territory comprises the Karachi municipal area and some parts of the adjoining Thatta and Lasbela districts, representing a franchise area of about 6,000 sq. km. KESC's distribution operation is essentially centralized. WAPDA supplies all other areas of the country, a franchise area of approximately 770,000 sq. km., through a largely decentralized system of eight area electricity boards.

Currently, total installed capacity of the two systems is 8899 MW of which 7039 MW is owned and operated by WAPDA and 1723 MW by KESC[3]. Another 137 MW is available to KESC from KANUPP. WAPDA's generation includes 2897 MW of hydro-electric capacity, the balance being thermal units using coal, natural gas or heavy oil, gas turbine/combined cycle units fueled by natural gas or distillate, and diesel engines run on distillate. KESC has 225 MW

[3]WAPDA data taken from Asian Development Bank, Appraisal of the WAPDA Twelfth Power (Sector) Project in Pakistan (Manila: Asian Development Bank, November 1991), 8 and 50-51 (Appendix 3). Figures are as of September 1, 1991.

of natural gas-fired gas turbines and 1498 MW of thermal units using mostly natural gas and furnace oil. The following is a breakdown of Pakistan's generating capacity.

SOURCE	WAPDA (MW)	KESC (MW)	TOTAL (MW)
Hydro-Electric	2897	-	2897
Thermal	2421	1498	3919
Gas Turbine	1721	225	1946
Nuclear	-	-	137
Total	7039	1723	8899

Sources: ADB, Appraisal of the WAPDA Twelfth Power (Sector) Project in Pakistan (Manila: ADB, November 1991), Appendix 3, 50-51. KESC Presentation to Secretary Poonegar, 1991.

The backbone of the transmission system comprises a 500 kV single circuit line running from Jamshoro in the south to Tarbela in the north, a second 500 kV single circuit line from Faisalabad to Tarbela, and a double circuit 220 kV line from Jamshoro to Karachi, connecting WAPDA and KESC. The balance of transmission operates at 220 kV, 132kV and 66 kV, and includes two 132 kV interconnections between the two systems. Power transfer capability between WAPDA and KESC is 850 MW, but in fact transfers are quite limited because the systems generally operate quite independently, and there is a shortage of firm generating capability.[4]

[4]Ibid.

The peak operation demands for WAPDA and KESC in FY 1991 were 6090 MW and 1224 MW respectively[5]. Annual growth for the next several years is expected to average around 9 percent for both systems[6]. Energy generated in FY 1991 was 34,443 Gwh and 7372 Gwh respectively. The breakdown of energy sold by economic group is as follows:[7]

%	Residential	Commercial	Agricultural	Industrial	Other[8]
WAPDA	32.4	4.3	21.0	34.3	7.9
KESC	35.86	18.39	0.48	40.29	4.98

While both systems appear to have a positive reserve margin, in fact WAPDA is forced to shed load regularly. In early 1991, this reached 837 MW or about 14% of WAPDA's peak generation demand that year at the low hydropower period. Hydroelectric capacity is reduced from mid-December to mid-February due to low irrigation requirements and around mid-May when reservoir levels at Mangla and Tarbela are low. KESC is able to export some power to WAPDA to reduce the generation capacity shortfall during these periods. In 1990, WAPDA exported 171 Gwh to KESC and imported 264 Gwh. Extensive generation and transmission plans are in progress for both utilities.

Despite the fact that KESC's all-thermal generation is more costly to operate than WAPDA's hydroelectric/thermal mix, the Government requires KESC to maintain the same electricity tariff as WAPDA, in order to apply a uniform electricity tariff nationwide. The tariff is determined by upper levels of Government based on estimates by the Energy Wing of the Ministry of Planning and Development of the economic cost of supply for different energy sources, adjusted from time to time to reflect changes in market conditions. A recent survey, the Integrated Operations and Tariff Study for WAPDA and KESC, prepared for the Government recommends in part, rationalizing the tariff structure by:

- introducing an appropriate time-of-use tariff
- eliminating the flat rate unmetered agricultural tariff
- eliminating the block structure of the commercial tariff

[5]Ibid.

[6]Ibid, 12.

[7]Ibid, 8.

[8]Ibid, Appendix 5, 2. KESC figures are taken from A Presentation to Secretary Poonegar prepared in 1991 by KESC Management Studies Department. Figures for public lighting are included in "Other" section of this table.

- appropriately merging blocks of domestic consumption
- consolidating the fuel adjustment surcharge into the base tariff

The study findings are currently under detailed consideration by the Government which has formed a joint committee to implement the findings.

b. Private Power Program

Energy supply and demand analyses conducted by the Energy Wing of the Ministry of Planning and Development predict that in the future, the availability of commercial energy will become a severe constraint on sustained economic growth in Pakistan. Furthermore, sustained economic growth over the medium and long-term requires that the GOP rationalize its public expenditures and reduce its fiscal deficit. Since the energy sector accounts for approximately 25% of these expenses, and since rapid economic growth in recent years has resulted in a significant increase in the consumption of commercial energy, the GOP has embarked on a program to expand and develop the country's energy sector. This program focuses on:

- promoting plans and programs aimed at exploring and developing domestic energy resources thereby reducing dependence on imported sources;
- strengthening the ability of enterprises within the sector to be self-sustaining;
- increasing private sector participation in the development of the energy sector through Build-Own-Operate (BOO) and Built-Operate Transfer (BOT) schemes; and
- streamlining pricing policies.

As part of this program, the GOP has begun to emphasize least cost development planning in the generation, transmission and distribution segments of the sector and has begin to rationalize investments through the development of a Core Investment Plan.

In addition, institutional changes have been implemented to encourage private participation in the development of the sector. International donor funds were used in 1988 to establish the Private Sector Energy Development Fund (PSEDF) which is administered by the National Development Finance Corporation (NDFC) which provides "mezzanine" financing of up to 30% to sponsors of private power projects. A number of proposals have been received the most advanced of which is that of the Hub River Power Company which plans to erect a 1,292 MW plant in Baluchistan. Other projects under consideration include two combined cycle power plants at Nandpur Gas fields at Kabirwala and at the Uch Gas fields in Baluchistan for a total of about 800 MW.

c. Privatization

In May 1991, the Prime Minister directed the Chairman of WAPDA to launch a bold initiative to privatize the existing power system as rapidly as possible. To assist in implementing this directive, the Chairman retained an international Advisory Team funded by the U.S. Agency for International Development, to develop a strategic plan that will ensure the long-term goal of bringing electricity to all of Pakistan's people while introducing private ownership, managerial autonomy, accountability, competition and profit incentives throughout the sector. A further objective was to rationalize prices and social subsidies, where necessary, while maintaining selected socially desirable programs including rural electrification and low income "lifeline" rates.

The Strategic Plan which was prepared by International Resources Group; Putnam, Hayes & Bartlett; and Hunton & Williams is now being submitted for consideration by the Government of Pakistan (GOP). It recommends that the Pakistan power sector be restructured to separate the transmission, generation and distribution functions. A single transmission entity would buy power from a number of generating companies, and sell that power to a number of distribution companies or area electricity boards. Provision would be made for large industrial customers to purchase directly from the transmission company, or to negotiate directly with generators for supply wheeled through the transmission system. A National Regulatory Authority would be set up to establish retail rates that accurately reflect the costs of providing electric service and eliminate cross subsidies. The Transmission Company, large hydroelectric plants and the Area Electricity Boards would be regulated, while the thermal generating and small hydro companies would be virtually unregulated. Government subsidy of rural electrification and "lifeline" rates would be paid directly to the Area Electricity Boards. Should the Government decide to maintain uniform nationwide electricity tariffs, any subsidies required to achieve this would also be paid directly to the Area Electricity Boards. It should be noted here that decentralization of WAPDA's power distribution commenced five years ago and is showing significant reduction in power distribution losses through expansion and rehabilitation actions and computer aided planning.

KESC is presently organized as a vertically integrated corporation which includes all three electric supply functions--transmission, generation and distribution. While the Strategic Plan does not specifically address KESC, it would seem appropriate that such a restructuring should at some point include the system and facilities comprising KESC. However, there does not appear to be any technical reason why restructuring of KESC and WAPDA must occur simultaneously. In fact, the ease with which a restructuring of KESC can be implemented could depend on the company's ownership. Clearly, it could most easily be accomplished during the period that the majority of KESC stock is owned by agencies of the Government of Pakistan. Once KESC is privatized, restructuring could clearly be rendered more difficult if a substantial percentage of the private investor stock were voted against a KESC breakup unless there were other safeguards to protect the GOP's flexibility. Corporate law requires that 75% of the stock be voted in favor of certain relevant types of resolutions.

If restructuring of the balance of the power sector were implemented without a KESC restructuring, KESC would appear as a generator to the transmission entity when it had surplus power to sell, and as a large industrial or distribution entity when its generation was insufficient to supply its connected load. The distribution customers of KESC would be captive to the utility during this interim period, but the same rules for distribution energy rate would apply as for other distribution entities, viz. rates based on cost of supply with direct GOP subsidy of "lifeline" services and rural electrification, or alternatively, direct GOP subsidy to obtain nationally uniform rates with additional subsidy of "lifeline" services and rural electrification.

The reorganization of KESC would almost certainly require at least three steps: firstly, setting up a holding company with individual transmission, generation and distribution subsidiary corporations; secondly, spinning off the subsidiary corporations as independent corporate units; and thirdly, merging the KESC transmission corporation with the nationwide transmission entity. There is some flexibility of timing as to when the three elements would be fully functional operationally as independent entities, but clearly the transition must occur before the second and third steps are completed. If further division of the present KESC system is contemplated in the generation and distribution areas, a detailed evaluation should be undertaken to ensure long-term reliability and profitability of each individual block. For the generating plants, consideration should be give to the present and future roles of individual generators for base load, cycling or peaking operation. For the distribution areas, consideration should be given to present and future load patterns, and to the nature and size of anticipated load growth.

An additional important consideration in any KESC restructuring will be the allocation of the company's resources in functions not directly tied to operations, e.g., legal, financial and administrative individuals and departments; certain technical personnel; and warehousing and stores personnel and facilities.

2. Capital markets and stock exchange

a. Current structure

The capital market in Pakistan is dominated by the Karachi Stock Exchange (KSE). As of November 1, 1991, 523 companies were listed on this exchange, for a total market capitalization of Rs. 114 billion. Market activity increased at an unprecedented rate during 1991, as is detailed in the section on recent developments which follows.

The KSE is supplemented by the Lahore Stock Exchange (LSE). Much smaller, the LSE nevertheless offers the KSE a degree of competition. An exchange is also being set up in Islamabad. Coordination among these exchanges--and oversight of securities laws and regulations--is the responsibility of the Corporate Law Authority (CLA).

The KSE-50 Index in existence since 1981 proved inadequate in determining price trends and has recently been replaced. The new KSE-100 Index is an attempt to correct past deficiencies. The Index contains a diverse sample of 100 stocks that are traded on the Karachi Stock Exchange.

The stocks included have a combined market value of about Rs. 57 billion out of the total market value of some Rs. 114 billion for over 500 stocks listed on the Exchange. The Index therefore represents about 50% of the total market capitalization of the Pakistan Equity Market. Pegged at 1,000 in November 1991, the index hovered over 1700 as recently as January 1992, and is now (February 10, 1992) at around 1400. The new Index should be of significant value to investors, providing them with a more reliable indicator of local market activity than has been available in the past.

The sectoral distribution of the KSE market capitalization at November 1, 1991 was as follows:

Sectoral Distribution	%
Financial Institutions	13.7
Textiles	18.8
Commodities	16.9
Fuel and Energy	16.9
Industrial and Commercial	33.7

KESC's weighing in the 100 index is the 4th highest, at 5.67%

Source: "An Introduction to KSE 100 Index," Karachi Stock Exchange, November 1, 1991.

b. Financial Institutions and Instruments

Of the financial sector institutions and instruments listed on the Karachi Stock Exchange as of November 1991, the most important in terms of market capitalization were modaraba funds and investment banks. The following table shows their relative weight in the sector:

Financial Institutions and Instruments	Market Capitalization (thousands Rs.)	% of Sector
Modaraba Funds	5,040,263	31.9
Investment Banks	4,942,002	31.3
Insurance Companies	2,469,364	15.6
Leasing Companies	1,816,400	11.5
Mutual Funds	1,540,110	9.7
Total	15,808,139	100.0

Source: KSE Annual Report, 1991.

A modaraba fund is an Islamic banking instrument created primarily for project financing. It is listed on the stock market and its certificates are quoted and traded in the same way as shares. Modaraba shareholders, however, have no voting rights and thus no influence. The fund is managed by a modaraba management company which is paid expenses plus 10% of profits. The manager must own a minimum of 50% of the modaraba; as a subscriber, he is eligible for a prorata share of profits on his certificates. A modaraba must be approved by a religious board to ensure that its intended purpose is Islamic.

Modarabas have achieved considerable market acceptance in Pakistan. As of the end of October 1991, over twenty-five modarabas had been organized with total paid-up capital exceeding 22 billion and market capitalization exceeding Rs. 5 billion.[9] Almost all of these funds have been oversubscribed. Modarabas are beginning to be explored for use in private power projects and in the privatization of power plants. Importantly, the equity mobilized by a modaraba could be used on one or more projects, an improvement over current practices of raising funds on an ad hoc basis.

Pakistan's eight investment banks are new participants in the country's capital markets: they have all been floated or created since 1989. The services provided by investment banks in Pakistan include corporate and project financing; portfolio management; trading in Government

[9]From "An Introduction to KSE 100 Index," November 1, 1991. As of February 10, 1992, thirty-six modarabas were listed on the KSE, as reported in the Dawn.

and corporate debt securities, corporate and Modaraba equities; and the underwriting of new equity issues and corporate debt issues.

No commercial banks were listed on the KSE stock exchange as of the end of 1991 because they were Government-owned and controlled until recent months.[10] Six local and twenty-two foreign commercial banks currently operate in Pakistan, and licenses have been granted for ten new commercial banks. Two local banks, the Muslim Commercial Bank (MCB) and the Allied Bank of Pakistan, were partially privatized in 1991, and two other local commercial banks are currently being returned to the private sector. The commercial banks cover such service areas as foreign trade arrangements, working capital, term finance and retail banking. In addition, these banks play a major role in underwriting.

c. Recent developments

- Recent GOP legislation

In 1991, the implementation of new GOP policies and measures altered Pakistan's capital markets environment. In an attempt to liberalize the economy, the Government reduced import tariffs; strengthened export incentives; deregulated banking, financial and foreign exchange sub-sectors; and, most importantly, privatized a number of public sector enterprises.

Pakistan International Airlines (PIA) appeared to be an obvious candidate for privatization with the highest paid-up capital of any company in the country (approximately Rs. 27.36 billion in November 1991). PIA's share offering was not a success, however, because a change in management control was not part of the arrangements. A more successful offering was that of Askari Commercial Bank. When its new issue was floated in January 1992, Askari's shares were oversubscribed by nine times. The GOP is continuing in its policy of promoting disinvestment and privatization. The Pakistan Telecommunications Corporation has been targeted for privatization in the near future.

- Stock market upsurge

The GOP's measures to liberalize Pakistan's economy resulted in a large injection of foreign funds into the equity market and a general stock market upsurge. 1991 was a year of record growth at the Karachi Stock Exchange. Total market capitalization rose from Rs. 54.23 billion in October 1990 to Rs. 114 billion on November 6, 1991, an increase of 210%. The General Index (KSE-50) grew 168% during that period.[11]

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[10] Askari Commercial Bank was listed on the KSE as of February 9, 1992, as reported in the Dawn.

[11] In January and February of 1992, shares on the KSE fell steadily as nervous investors reacted to the escalation of tensions between Pakistan and India. Having exceeded 1700 in January, the

New listings have also accelerated at an unprecedented rate. The KSE received listing applications from 79 companies. Forty-two of these companies have been formally listed, raising the number of listed companies to 523. These 42 companies represented investment opportunities totalling some Rs. 1,537.556 million; subscriptions for these shares by the general public and NIT amounted to Rs. 11,371.703, over seven times the capital offered. Similarly, trading activity has more than doubled. The volume of turnover during January through October 1991 rose from 206.5 million shares to 456.9 million shares for the same period in 1991. Average daily turnover has increased correspondingly, from 1.105 million shares to over 2.443 million shares.

3. Company profile of KESC

a. General history

The Karachi Electric Supply Corporation (KESC) was established in 1913 under the Indian Companies Act of 1882 as a joint stock company to supply electric power to the City of Karachi and surrounding areas. The original authorized share capital as of December 31, 1913 was Rs. 1,000 and the issued, subscribed and paid-up capital was Rs. 600. In 1952, the GOP purchased 51% of the company's outstanding shares and increased its shareholding in the company through increases in the authorized and paid-up capital of the company to its current position of about 90% of the company's shares. These shares are held by a number of GOP-owned financial institutions, insurance companies and other entities. As of November 12, 1991, these shares were distributed as follows:

KSE-100 Index is now hovering at its resistance level of 1,400 points, which is still above the November index level of 1,000.

SHAREHOLDER	No.	Amount of Shares Held	%
Government of Pakistan	1	37,751	0.03
Financial Institutions[12]	17	33,201,305	30.66
Investment Companies	5	31,945,110	29.50
Insurance Companies	14	35,185,452	32.50
Joint Stock Companies (resident)	32	978,839	0.90
Joint Stock Companies (non-resident)	1	16,241	0.01
Charitable/Educational Institutions	9	1,487,039	1.37
Individuals (resident)	5,693	5,386,405	4.97
Individuals (non-resident)	41	35,648	0.03
Total	5,8[illegible]	108,273,790	100.0

Source: KESC response to a request from Secretary of Water and Power, December 22, 1991.

The largest shareholders are the National Bank of Pakistan (23.1%), the State Life Insurance Corporation of Pakistan (30.6%), the Investment Corporation of Pakistan (28.4%) and United Bank (5.8%).

The current mission of KESC is to:

- Generate, transmit and ensure smooth uninterrupted electric power supply and distribution to consumers in and around the city of Karachi at optimum rates;
- Ensure the long term financial stability of the corporation;
- Ensure reasonable dividends to its shareholders; and
- Ensure the welfare of its employees.

The company's authorized share capital as of June 1991 was Rs. 2.5 billion. Of that, Rs. 1,082,738,000 was issued, subscribed and paid-up.

[12]This includes the shares held by the Trustee Department of the National Bank of Pakistan for the National Investment Trust (NIT).

b. Nature of KESC's business

KESC's licenses entitle and oblige it to provide transmission, generation and power distribution to the corporate area of Karachi and its environs. As of the end of FY91, KESC served 1,090,711 customers. For the six years ended June 30, 1991, KESC's service expanded, with new customer connections as follows:

1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
48,591	40,229	41,061	42,580	47,171	44,000

Source: KESC

- Transmission

The utility's transmission system comprises 31 substations with a total power transformer capability of 1653 MVA, interconnected by the following circuit kilometers of transmission line:

220 KV	Overhead	169.74			
132 KV	Overhead	556.50	132 KV	Underground	6.16
66 KV	Overhead	134.54	66 KV	Underground	22.70

Plans are being implemented to add eight new substations at Orangi, Jacob Lines, Clifton, Liaquatabad, Defence Phase VI, Civic Center, Garden East and Gulshan and to extend three existing substations, with related 132 KV overhead and underground connections. These expansions are being funded by U.K. and World Bank energy sector loans.

- Generation

To meet increasing demand for power within its licensed area, KESC has embarked on the modernization and expansion of its generating facilities as well as the distribution and transmission systems. KESC started construction of additional units at Bin Qasim and associated transmission systems in 1986 and 1988.

In addition, the GOP is proposing the installation of another 210 MW unit at Bin Qasim including a double circuit 220kV transmission line from the power station to Korangi West Grid Station which is expected to be commissioned by 1993. Other expansion activities are planned for two West Wharf units of 210 MW each (to be privately owned and operated) and the associated 220kV transmission facilities. These units will be commissioned in 1994 and 1995 and the transmission facilities will be commissioned in May 1993.

Generation plans for the future entail 1630 MW of new plant and retirement of 378 MW, for a net gain of 1252 MW. Peak demand has increased from 540 MW in FY81 to 1220 MW in FY91, with a 128% increase in energy generated during the same period. Energy generated in FY91 was 62,929 Wh.

- Distribution

The distribution system comprises 3,983 substations with a total 11 kV distribution capacity of 2103 MVA. Interconnections and service connections total the following circuit kilometers:

11 Kv	Overhead	1120.5	11 Kv	Underground	2520.6
400 V	Overhead	6901	400 V	Underground	442.9

The system currently serves the following economic groups in the numbers indicated:

	Residential	Commercial[13]	Industrial	Agriculture	Street Lights	Other
Consumers	794,998	236,342	21,825	1,062	70	407
Consumption (Gwh)	1,782	914	2,002	24	84	163
Consumption (%)	35.86	18.39	40.29	0.48	1.7	3.28

Source: KESC, Presentation to Secretary Poonegar, 1991.

c. Regulation of KESC's operations

KESC's operations are governed by the Electricity Act (1910) and Licenses issued under the Act. According to the terms of Section 3(e) of the Act, a License is not an exclusive license as

> "The grant of a license in this Part for any purpose shall not hinder or restrict the grant of a license to another person within the same area of supply".

This calls into questions the commonly held belief that KESC has a monopoly in its license area.

In addition, the Act makes provision for a license to be revoked for various causes by the Provincial Government. If a license is revoked the licensee is required to sell the undertaking to

[13]Commercial usage includes that of KWSB, KMC and other municipal agencies. Figures cited are for 1990-91.

the local government or the Provincial Government at fair market value or, if neither wishes to purchase the undertaking, to a third party. Goodwill and loss of profits will not be recognized in such a sale.

Within fifty years after the commencement of a license and at twenty year intervals thereafter, the local authority or the Provincial Government may require the licensee to sell the undertaking to either one of themselves on the same terms as a revocation. In the case of KESC the next option for such action is 2003, which is only eleven years from the present. Investors may be uneasy about the imminence of the next option date and may require that a new license be issued so that the 50 year period may apply.

Under the terms of the Act, the revision of rates does not appear to be contemplated with the regularity that is demanded under current conditions. Article XI of the Schedule to the Act indicates that rates may only be revised at five-year intervals. It may be necessary for the Schedule to be updated in this regard.

d. Management and employment

According to the KESC Articles of Association, the overall management of the company is the responsibility of the KESC Board of Directors. The number of Directors is limited to 13 and a majority is required to pass resolutions.

The Board of Directors is required to appoint a Managing Agent of the Company, in this case, the Pakistan Electric Agencies Ltd. to manage the company under its supervision and control. Among its powers, the Agent can enter into contracts on behalf of the company and hire, promote and remove employees.

Article 77 of the Memorandum and Articles of Association of the company gives the Managing Agent the right to nominate a Director to the Board of Directors who "shall" be the Chairman of the Board. Apart from this requirement, there are no other stipulations in these documents as to the representation on the Board of various groups.

The current Board which was elected on February 1, 1992 is composed of 12 members in addition to the Chairman providing representation as follows:

Federal Government	4
Government of Sindh	3
Government of Baluchistan	1
Financial Institutions	2
Private Shareholders	2

This differs from the composition of the Board of Directors before 1984 when private shareholders had three Directors and financial institutions had one.

As discussed previously, KESC is managed under a ten-year agreement with the Pakistan Electric Agencies, a private company which serves as the company's Management Agent[14]. Prior to 1984, the Agency Board was made up of the Chairman of the KESC Board of Directors as well as the Managing Director of KESC, the Joint Secretary for Power (Ministry of Water and Power) and the Financial Advisor (Ministry of Water and Power). The present Agency Board is chaired by the Member (Finance) of WAPDA and is composed of the Managing Director of KESC, the Member (Power) of WAPDA, the Joint Secretary (Power) of the Ministry of Water and Power and the Financial Advisor (Ministry of Water and Power). The Agent is responsible for appointing the Managing Director.

The management reality of KESC appears to differ from the structure outlined in the Articles of Association. The current Chairman of the KESC Board is the Chairman of WAPDA and not the Director representing the Management Agent, in this case the Member (Finance) of WAPDA.

KESC has a total staff of 13,771 of which 863 are officers and remainder are staff and trainees/apprentices. The KESC labor force is a highly politicized one characterized by strong union representation and activism.

e. Financial overview

According to financial figures provided by KESC, the company showed a profit of Rs. 594.92 million for FY 1989-1990. This profit included subsidies worth Rs. 796.82 million. This leads to the conclusion that without the benefits of these subsidies, KESC would have shown a loss of Rs. 201.90 million for that year. Figures for 1990-1991 indicated that KESC's position deteriorated further since subsidies totalled Rs.1,399.70 million whilst profits including those subsidies was only Rs. 472.55 million indicating that, without subsidies, the company would really be operating at a loss of Rs. 927.15 million.[15] The subsidy of approximately Rs. 1.4 billion represents 20% of the revenue from electricity sales, which implies that a 20% rate increase would be needed to replace the subsidies.

One of the most critical problems that currently faces the management of KESC is its inability to collect outstanding receivables particularly those that relate to electricity usage by the provincial and local governments.

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[14]The current agreement expires on March 31, 2001.

[15]The loss would actually have been higher since interest on additional financing to replace the case flow reduction would also have to be paid.

KESC's recent dividend record is as follows:

Year	Paid-up Capital (Rs. thousands)	Cash Dividend (%)	Bonus Share Issues (%)
1991	10,827,320	0	12.5
1990	8,661,850	0	25
1989	7,532,040	10	15
1988	7,532,004	10	12.5
1987	6,086,500	10	10

In 1990 and 1991, KESC was unable to pay cash dividends because of restrictions imposed by the ADB.

As of September 30, 1990 KESC's accounts receivable position was as follows:

Accounts Receivable	Amount (Rs.m)	Average monthly sale	No. months outstanding
Federal Government	431.859	75.76	5.7
Provincial Government	139.856	5.72	24.5
Karachi Development Authority	25.996	1.23	21.1
Total Provincial Govt.	165.852	6.95	23.8
Karachi Municipal Corporation (KMC)	34.513	1.71	20.2
Zonal Municipal Committee (East)	38.689	1.40	27.6
Zonal Municipal Committee (South)	38.915	1.82	21.4
Zonal Municipal Committee (Central)	16.135	1.28	12.6
Zonal Municipal Committee (West)	21.064	0.69	30.5
Karachi Water and Sewerage Board	424.918	19.10	22.3
Total Local Government	574.234	26.00	22.1
Public Sector Average	1,171.945	108.71	10.8
Private Sector	1,571.873	452.24	3.5
Grand Total	2,743.818	560.95	4.9

Source: Attachment to Letter from Mr. I.Y. Chung/ADB to Mr. R.A. Akhund/Ministry of Finance, March 5, 1991.[16]

[16]Updated information as of July 31, 1991 puts KESC's position as follows:

Federal Government	374.572 million
Provincial Government	51.064 million
K.D.A.	96.584 million

This analysis shows that the Federal and Provincial Governments had receivables outstanding the equivalent of 10.8 months and a corresponding 3.5 months for the private sector and that the overall KESC position on receivables was 4.9 months, corresponding to some Rs. 2.74 billion. Within these broad categories, the local government agencies show higher delinquencies than this weighted average. KWSB, KMC and the ZMCs (all local government authorities) have a total of Rs. 574 million outstanding some 22.1 months.[17]

KESC argues that its inability to collect its accounts receivable constrained its ability to finance the local cost component of its capital investment program. Therefore, it was proposed to float a bond issue of Rs. 2 billion in 1991 which has not been implemented. KESC's current accounts receivable position is in violation of loan covenants imposed by the Asian Development Bank (ADB), one of KESC's largest donors, which require maintenance of an overall account receivable position of less than three months. KESC's failure to comply with this covenant has resulted in the suspension of additional financing for KESC.

In addition to the covenants relating to accounts receivable, there are other covenants that have a direct impact on KESC's financial future. The GOP has agreed to eliminate subsidies by FY 1991 to meet a covenanted self-financing ratio of 25% and a debt service ratio of 1.3 in FY 1991. Furthermore, the ADB has imposed restrictions on the payment of cash dividends while subsidies continue which raises implications for structuring and implementing any future share offerings.

Transmission and distribution losses increased from 19.77% to 20.84% and estimates for 1991 put these figures at around 26%.[18]

B. Objective and Scope

In an effort to improve the performance of the company and to further GOP privatization objectives, the Ministry of Water and Power sought technical assistance through USAID/Pakistan

KMC and ZMCs	217.061 million
KWSB	627.614 million

[17]KWSB is a department of KMC and each of the ZMCs have a separate legal status. However, KMC does not claim responsibility for ZMCs outstanding electricity bills. KWSB has a number of financial problems and faces serious cash flow constraints due to a number of deficiencies such as inadequate tariffs, poor bill collection and metering practices and large outstanding receivables. The chances of recovery are therefore very poor.

[18]It is not clear whether these losses are due primarily to the overload of the systems or to direct connection to the distribution system.

to achieve the privatization of the company through a share offering. This technical assistance was aimed at providing the Ministry with guidance in structuring a share offering, addressing such issues as the size and pricing of the offering, the impacts of the offering on the market price of the share, the adequacy of available financial information to conduct necessary financial analyses and the amount of time required to perform asset valuations.

In order to achieve these objectives, the Price Waterhouse team accompanied by an International Resources Group (IRG) consultant:

- Conducted meetings and interviews with key representatives of the GOP including the Secretary of the Ministry of Water and Power; the Chairman of WAPDA; the Member (Power) of WAPDA; KESC senior managers including the Managing Director, the Chief Law Officer, the Chief Financial Officer, the Chief of Management Studies, the External Auditors and a project engineer; and representatives of the ADB;

- Conducted meetings with USAID/Pakistan representatives;

- Conducted interviews with representatives of the Karachi Stock Exchange, commercial banking institutions, potential underwriters, selling agents and share registrars, brokerage houses and investment banks based in Karachi and the Corporate Law Authority; and

- Reviewed background material on KESC including the latest annual reports and long-term financial projections and other documents such as the KESC Memorandum and Articles of Association, the Karachi Electric License and the Lasbela Electric License, the Electricity Act, the 1991 Managing Agents Agreement with Pakistan Electric Agencies (Pvt.) Ltd., the Pakistan Companies Ordinance, the Securities and Exchange Manual and the Capital Issuance (Continuance of Control) Act, the KESC tax computation, the actuarial report on the Gratuity Scheme, long-term loan agreements and subsidiary agreements, GOP directives concerning foreign debt, the fuel and power purchase and sale agreements and the octroi claim by the Sindh Government.

Based on these meetings and reviews we:

- Determined the objectives of the GOP and attributes of the sale which would be considered desirable by both the Ministry of Water and Power and WAPDA;
- Analyzed the capacity of the capital market in Pakistan, the methods used to effect share offers in Pakistan and existing investor perceptions about KESC to determine the likely size of a share offering and associated costs;

- Identified potential obstacles and analyzed their impacts on the success of the transaction, developing recommendations for possible strategies to reduce these impacts;

- Identified and analyzed five possible structures for a KESC share offering based on objectives defined previously and other analyses conducted; and

- Developed an implementation plan for the use of one of the structures most likely to achieve the privatization objectives of the GOP and improve the long-term financial performance of the company.

C. Organization of the Report

The report is organized in five sections. Section I contains an Executive Summary and Section II presents background material on Pakistan's energy sector and related privatization activities, the Pakistan capital markets and the activities of the Karachi Stock Exchange and a brief analysis of KESC, focusing on the nature of its business, its management structure and its recent financial performance.

Section III contains analyses of the key issues that determine the size of a potential share offering and the price that can be obtained on the market. These issues include market acceptance, the capacity of the local market to absorb a share offering and current operational and financial performance of the company which will impact on the company's long-term ability to provide an acceptable return to investors. In addition, this section contains possible strategies for structuring a share offering.

Section IV contains our detailed conclusions and recommendations to the GOP for structuring a KESC share offering to increase private ownership of the company. Finally, Section V contains a suggested scope of work for a full study of the privatization of KESC.

III. STRUCTURING A SHARE OFFERING

A. Introduction

In designing share offerings especially in the context of privatization programs, there are several key elements that must be analyzed to ensure that the offering is a success, not only in terms of market acceptance, but also in other terms that relate to such issues as the long-term viability of the enterprise, improvements in the company's efficiency and consequential reduction in the costs of service to the general public, the improvement of the quality of service, the assurance of a fair price paid to the GOP and the general growth and efficiency of the economy.

In considering the design of a share offering for KESC, we consider the following elements to be key in ensuring the success of this transaction:

- Clearly defined objectives that are widely known which are used to measure the success of the transaction;
- Strong investor interest that increases market acceptance;
- Return on investment commensurate with the risk associated with the investment; and
- Implementation of the transaction in a competent, professional and ethical manner.

B. Defining Objectives

Establishing clearly defined objectives at the very beginning of the process reduces opportunities for criticism at the end that the transaction was unsuccessful. Not only should the GOP define these objectives at the beginning, but it should also make these known as widely as possible before the implementation of the transaction. The GOP's current privatization program is part of an overall strategy to promote foreign investment in Pakistan, and recent criticism of the GOP's program alleged that transactions to date have not demonstrated transparency and have not contributed to the development of the domestic capital market.

Other privatization objectives could relate specifically to the financial performance of the company, and these objectives are usually the most common ones for designing and implementing privatization programs. They relate to increasing the efficiency of the state-owned enterprise (SOE), improving the quality of service at reduced costs to the general public and reducing government deficits associated with state ownership of enterprises. In the case of KESC, these objectives are not being met. Current GOP control of KESC has exacerbated problems in the management and operation of the company to the level that these have become severe threats to the continued efficiency and financial viability of the company. These problems include:

- Politicized labor and employment practices over the years which have resulted in an untenable breakdown in discipline and in overstaffing; and

- The toleration of non-payment by other agencies of the Federal and Provincial Governments and SOEs for electricity consumed which has placed the company under financial pressure.

These circumstances have increased the reluctance of donor agencies who are the primary sources of long-term financing to provide KESC with urgently needed development funds to address its capacity shortage. In addition, these financial constraints have caused a backlog of maintenance projects which affects the reliability and efficiency of the system and quality of service.

KESC is a high-profile company which is already quoted on the Karachi and Lahore stock exchanges, with some 5,700 private shareholders owning about 7% of the company. Based on these initial observations, KESC appears to be a good candidate to demonstrate (i) the broadening and deepening of the domestic capital markets and (ii) increasing transparency in the conduct of privatization transactions. At present it is estimated that only 12% to 15% of the population invests in financial instruments. Some 70% keep their savings in cash at home ("under the mattress") and much investment is made in jewelry, real estate and hard currency. A share offering open to all citizens on the same terms is clearly transparent.

In determining whether a share offer has been a success or a failure the following criteria could be applied in the context of privatization:

- The offer must be fully taken up or oversubscribed

If the offer is not fully taken up (including a case where the underwriters have to take up shares) then the share will perform badly on the after-market for a significant period. Not only does this have adverse political repercussions, but it also makes future sales of the share to the market very difficult. Avoidable causes of a poor response include (i) a price for the share which is perceived as too high (ii) an offer which is too large for the market to absorb comfortably.

- The price must not be perceived as a "giveaway"

Even if an offer is fully taken up or oversubscribed and thus successful in terms of the criterion discussed above, there will be political repercussions if the price is perceived as being too low. One mitigating factor even in this circumstance is that if the offer is structured so as to provide all citizens with the same investment opportunity then allegations of insider activity and lack of transparency are not sustainable.

- There should be a large number of successful applicants in the share offer, including employees

This success factor is particularly true of privatization as it will generally be of benefit to the perception of the privatization program, a key GOP policy.

- Improvement in management

In keeping with privatizations in general and not just in relation to privatization achieved through share offers, the transaction should promote improvement in the efficiency of the general economy. In the particular case of KESC there is a consensus that this objective will not be attained unless there is a change from political management to management which is free to apply commercial criteria in decision making.

C. Pricing a Share Offering

The pricing decision in a share offer was described by the architect of the first British Telecom share offer while testifying before a House of Commons Committee following allegations of underpricing as being "like trying to balance an egg - you can't - it must fall one way or the other." He was explaining that a slight overpricing could cause an offer to fail while a slight underpricing could cause it to be a "runaway" success. It is usually advisable to err on the side of underpricing in view of the undesirable long-term effects of an unsuccessful offer.

The pricing of a share depends upon fundamental and technical factors, both of which are equally important. Fundamental factors include the future profitability of the company and the underlying security provided by a break-up value. Future profitability depends on the company's share of the market and the quality of its product, the degree of competition and government intervention in setting prices or other regulatory matters, the competence of its management and the strength of its balance sheet. Technical factors include the state of the stock market in general and the supply and demand relating to the share.

In the case of KESC under current conditions the following fundamental factors apply:

Positive

- KESC is the only supplier in the market
- There is scope for improvements in efficiency and cost reductions

Negative

- The company must depend on Government to allow appropriate rates
- Its main financier the ADB has suspended new credits

- It is precluded from paying a cash dividend
- Without subsidies KESC would record a loss
- Certain of the accounting policies cast doubt upon the quality of reported earnings
- Management has no control over the labor force
- Management is not given a free hand to disconnect customers having large overdue balances
- There is need for substantial capital expenditure
- The debt/equity ratio is probably at the limit of prudence
- There are substantial unresolved claims against the company
- Though it is the only supplier in the market area it does not have an exclusive license
- Relations with the Provincial Government, which has the power to revoke the license under certain circumstances, are poor
- In only 11 years time the local authority or the Provincial Government will have the option to acquire the undertaking.

The following technical factors now apply to KESC:

Positive

- The share is in short supply to the market
- Though there has been a recent decline in share prices the mood of the market is generally bullish

The absorptive capacity of the market can only be gauged by "educated guesswork" and a review of the recent past. Again, it is better to underestimate the capacity of the market because of the long term adverse consequences of a failed offer. Exhibit I describes the results from potential KESC share offerings based on a model assuming a price per share of Rs. 60 and 500,000 applications.

Exhibit I

BASE SCENARIO - RESULTS OF SHARE OFFERS

Proceeds:	% of Equity	No. of shares	Rs. per share	Rupees
Employees	2.0%	2,165,476	50	108,273,790
Private placement	26.0%	28,151,185	60	1,689,071,124
Public offer	25.0%	27,068,448	60	1,624,106,850
Exercise of option	17.0%	18,406,544	60	1,104,392,658
Total	70.0%	75,791,653		4,525,844,422
Expenses of public offer:	Commission			
Underwriting	2.0%			(32,482,137)
Brokerage	0.25%	500,000		(6,250,000)
Other expenses				(10,000,000)
Net Proceeds				4,477,112,285

Note: The remaining shares will be held by NIT (23%) and the existing private shareholders (7%)

TABLE SHOWING NET PROCEEDS VARYING THE SHARE PRICE AND NUMBER OF APPLICANTS (in Rs. billions)

		APPLICANTS				
		300,000	*500,000*	*800,000*	*1,000,000*	*1,500,000*
P	*30.00*	2.233	2.230	2.227	2.224	2.218
R	*40.00*	2.982	2.979	2.976	2.973	2.967
I	*50.00*	3.731	3.728	3.724	3.722	3.716
C	*60.00*	4.480	4.477	4.473	4.471	4.465
E	*70.00*	5.229	5.226	5.222	5.220	5.214

This section contains detailed discussions of all the factors listed here.

D. Fundamental Factors

As discussed previously, investor interest and market acceptance address not only the ability to place a share offering as quickly as possible, but to do so at a fair price. This price is determined by the market based on such issues as the ability of the company to generate cash flows sufficient to provide shareholders with a return on their investment relative to the risk associated with the investment. There are several significant limitations currently associated with KESC which affect the quality of its shares and, consequently, the perceived ability of the company to fulfill investor expectations.

1. Accounting policies

The nature and importance of the impact of KESC's current accounting policies and the resultant quality of reported earnings on a share offering and on the determination of share price depend on GOP privatization objectives. It is likely that a small (e.g., 18% of equity) share offer will not require much change in the company's current accounting policies and the quality of its financial statements since the company is already listed and the market seems content (or at least reconciled) to the manner in which the financial statements are presented. However, a long-term investor seeking management control will require a "due diligence" review to be done on his behalf. Based on our review of the latest annual reports and those over the past five years, we have identified selected key areas that would be of concern to a future investor:

a. Asset valuations, depreciation and devaluation losses

KESC carries its fixed assets at the original rupee cost plus interest during construction and commissioning ("test operation") expenditures. In addition, devaluation losses on foreign loans are included in the cost of the assets to which the loans relate.

Depreciation is calculated on the total of all the above, and "additional depreciation" is charged on all the cost elements except the devaluation losses. This is a rough attempt to have sufficiently high depreciation charges to recognize replacement costs through additional depreciation and is based on the assumption that the devaluation element of cost does not require additional depreciation since the losses are a significant element of replacement cost.[19]

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[19]However, since the GOP is currently guaranteeing exchange rate losses through coverage provided by the State Bank of Pakistan, the full extent of devaluation losses is no longer reflected in the cost. Furthermore, the devaluation losses which have been recorded only relate to the outstanding loan principal.

A test of the adequacy of the depreciation charges over the past ten years to determine whether the provisions reflected replacement cost was performed by the ADB at our request.[20] The test using the GDP deflator for Pakistan showed that depreciation for 1991 should have been Rs. 1.907 billion instead of the Rs. 1.127 billion total charged in the financial statements for depreciation plus additional depreciation.[21] The cumulative 10 year underprovision of depreciation is estimated to be approximately Rs. 6.6 billion. The replacement cost of fixed assets according to this calculation is estimated to be Rs. 40.8 billion (gross) compared to the figure in the financial statements of Rs. 27.9 billion.

Based on this calculation it appears as though the accounting policy currently in use is not achieving its objective of reflecting adequate depreciation on a replacement cost basis.[22] Furthermore, the valuation of fixed assets in the balance sheet is a combination of historical cost and some element of recognition of replacement cost (through the devaluation losses). Therefore, the presentation of fixed assets in the financial statements is in accordance with neither the historical cost nor the replacement cost accounting conventions and is inconsistent with internationally accepted accounting principles.

b. Deferred taxation

Deferred taxation is an accounting concept that recognizes timing differences between the accounting recognition of revenues and expenses compared to the treatment of these items for tax purposes. For example, an expense may be recognized for tax purposes in one year but not be considered an expense from an accounting point of view in that same year. However, in a future year when there is accounting recognition of that expense it will not be tax deductible. In that future year a disproportionate tax liability will arise which might be unexpected by the shareholders unless the technique of deferred tax accounting is used.

The use of accelerated depreciation which is allowed for tax purposes--particularly the "Initial Depreciation" allowance of 25%--results in a large deductible item particularly in the year of the acquisition of an asset. However, depreciation for accounting purposes which reflects actual wear and tear or obsolescence is usually reflected in a lower depreciation charge. In future

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[20]The Price Waterhouse team drew on the resources of ADB consultant, Mr. Bernard Ivory currently in Karachi conducting an organizational review of KESC.

[21]The GDP deflator is crudely reflective of changing costs but a more refined method would have been the use of indexes applicable to the categories of equipment in the supplier countries (such as the U.S. Handy-Whitman indexes) which could be further refined to reflect exchange rate and customs duty changes. However, for the purpose of this report, we consider the GDP deflator to be sufficiently indicative.

[22]A logical means of achieving the objectives and one that is not as complicated is to index the assets and credit any increment above the previous valuation to a capital reserve account. Devaluation losses applicable to fixed assets should then be charged to the same account.

years, tax depreciation on the asset will dramatically decline and the accounting charge will be in excess of the tax depreciation, resulting in a timing difference. It is widely held that this concept is not applicable to utilities since they are always in an expansion mode and the timing difference in reality will never reverse.[23]

KESC calculates the full extent of the deferred tax liability annually and discloses this in the notes to the financial statements, but the extent to which the increase in the calculated liability is charged to income is arbitrary. Therefore, KESC's accounting practice does not conform to either the comprehensive deferred tax accounting, partial deferred tax accounting or no deferred tax accounting conventions but is a hybrid approach which is not recognized by internationally accepted accounting principles.

c. KESC's Provident and Gratuity Schemes

KESC operates two schemes dealing with termination benefits. These are a Provident Scheme (the Karachi Electric Provident Fund) and a Gratuity Scheme.

The Provident Scheme is equivalent to a cost-based pension scheme and the company and employees each pay into a fund which is administered by Trustees. There is a formal book of Rules and Regulations and benefits are based on the amount of contributions plus interest earned. The Provident Scheme presents no potential problems as far as the share offer is concerned.

The Gratuity Scheme has evolved over time and there is no consolidated book of rules. We understand further that it is not a contractual obligation of KESC, but we believe that it could be construed as such if put to the test in a court of law. Since it is the intention to convert the Gratuity Scheme into a formal pension scheme, the characteristic of the liability will then be that of a more binding obligation. Employees who are terminated or who retire or resign after 8 years of service are paid an amount equivalent to one month's pay at current rates for each year of service. This is equivalent to a benefit-based pension scheme. KESC does not fund this obligation and accruals are set up in the financial statements on a "net of tax basis taking into consideration the actuarial assessment of liability".[24]

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[23]However, if the new management of KESC decided that the future strategy of the company would be to purchase energy rather than build its own generating facilities, there may well be substantial deferred tax liabilities which would become actual. We note from the calculation of the company's deferred tax liability that the truly reversible items such as accrued gratuity and other provisions are not taken into account.

[24]We reviewed the actuarial report dated 1985 but it is too outdated for us to draw a conclusion as to the present adequacy of the provision for the liability in the accounts. The actuarial calculation also assumed that the scheme is funded and earning interest at the rate of 8%, neither of which is the case. The practice of showing the accrual net of tax compensates for omitting this timing difference from the deferred tax computation (see footnote 18) but this is a clumsy procedure.

Considering the size of the payroll of KESC this item is potentially a significant underecorded liability and a thorough investigation should be made of the legal and financial status of the scheme before the share offer is undertaken.

2. Deferred customs duties

At present KESC is allowed to import stores and equipment and clear the goods prior to the payment of duties. Duties are payable over six years with a three-year moratorium and are secured to the customs authorities by commercial bank guarantees. As of June 30, 1991 the amount payable was Rs. 804 million. The terms under which this arrangement may continue should be formalized prior to the share offer.

3. Termination payments to redundant employees

In many privatizations through the sale to single purchasers, the purchase price is usually adjusted in recognition of the need that the investors may have for rationalizing the workforce. This is not feasible in the case of KESC since the share is already trading and the sale will be to thousands of individuals.[25]

4. Managing Agents

One of the fundamental causes of KESC's problems is the arrangement entrenched in Article 99 of KESC's articles of association whereby broad powers "subject to the control and supervision of the Directors" "shall be in the hands of the Managing Agents of the Company". The Articles (Article 77) also prescribe that "The Pakistan Electric Agencies Ltd., as Managing Agents of the Company" has the right to nominate a Director who "shall" be Chairman of the KESC Board. The current agreement with Pakistan Electric Agencies Ltd. expires on March 31, 2001.

The Managing Agents arrangement has been identified as a fundamental weakness in the management structure of the company by virtually all consultants who have studied KESC over the past ten years and we have learned that in 1984 even the GOP's own Organization and Methods Division of the Cabinet Secretariat recommended the abolition of the arrangement. The state of indiscipline in the workforce and the lack of decisive action in the collection of municipal receivables is seen as being a direct result of the Managing Agents arrangement as it has severely weakened the nominal Board of Directors and is thoroughly politicized. The stage has now been reached where management is afraid to even send warning memos to workers and "does not dare" to report unfair labor practices to the Industrial Relations Commission although there has been ample cause to do so.

[25]It would not be advisable to sell shares at more than one price and the shares which are pre-placed with large investors should be sold at the same price as the shares destined for the general public.

Since under Section 206 of the Companies Ordinance Managing Agents may only be "appointed" in cases where the GOP controls a company, it would appear that with the transfer of management control to the private sector the "appointment" of such an agent thereafter would be illegal. However, since the "appointment" has already occurred, there is the question as to whether the status of the existing arrangement would be affected. Investors will clearly wish the agreement to be cancelled.

Clause 2(i) of the Agency agreement states "The compensation payable to the Managing Agents on premature termination of the agreement should be calculated at the rate of one year's average remuneration for every four years of the unexpired period of the Agreement". Based on this clause, it appears that KESC would have to pay the Managing Agents 10% of the average profits of KESC as compensation for termination.[26]

The GOP should negotiate a settlement of this matter before the offering is made.

5. Board of Directors

Article 79 of the company's Articles of Association states that:

> "The term of office of a Director, excluding the Director nominated by The Pakistan Electric Agencies Ltd. a debenture holder or any other Director nominated by PTC and other Redeemable Capital/Security, shall be three years from the date of election to office, in the manner prescribed by the Ordinance and these Articles unless any of them earlier resigns, becomes disqualified or otherwise ceases to hold office."

The new shareholders will obviously seek representation on the Board. In formulating the offer for sale it must therefore be clear as to how this can be achieved immediately following the completion of the offer.

The Articles and the Companies Ordinance indicate that Directors may be appointed at any general meeting and not just annual general meetings. An extraordinary general meeting may be convened (per Section 159 of the Ordinance and Article 35 of the articles) by the Directors and the Directors "shall" and "forthwith" call such a meeting on the requisition of 10% or more of the shareholders per Section 159(2) of the Ordinance. Section 181 of the Ordinance and Article 87 of the articles allows Directors to be removed provided that the number of votes supporting this action is at least equal to the minimum votes cast for the election of a director at the immediately preceding meeting at which Directors were elected.

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[26]With nine years to run, there are two four-year terms. The fee for each year is 5% of profits as defined.

Since at the recent election of the Board the minimum votes cast for the election of a director (in respect of Mr. Siddiqui) was 33,217,287 (30.6% of the present issued equity), the new shareholders must be able to obtain that number of votes to remove the present Board.

6. Regulatory framework

One of the most fundamental issues that will affect the future profitability of the company and, in turn, the quality of the share is the absence of a regulatory framework and economically rational ratemaking process in Pakistan. The present system of setting electricity rates to be charged to consumers can be regarded as being basically political. Rates are reviewed by an inter-ministerial committee which presents recommendations to Cabinet and the awards made usually reflect a mix of commercial needs, response to pressure from international funding agencies and social engineering (such as cross-subsidies).

Even though there seems to be little concern among market professionals about the process of setting rates, this will emerge as an issue of significant importance to any investor group seeking control of the company. In the event that the GOP decided to divest a small amount of stock and not deliberately seek to shift control it might be possible not to make any fundamental change in the method of setting rates.

Market professionals rely on the fact that KESC provides a basic service, has a perceived monopoly in its License area and "cannot be allowed to go bankrupt." Moreover, as the GOP and/or NIT would under any scenario discussed in this report retain a significant stake in the company, it is perceived as unlikely that it will allow the company to operate at a loss. However, it is not enough to have assurance that the company will not be allowed to fail.

Investors require assurance that they will earn a return on their investment. International investors will not be encouraged by the fact that the GOP will still have a significant stake in the company since experiences in other countries have shown that political expediency motivates national governments more often than the profitability of enterprises in which they have an ownership interest. These experiences have caused large, sophisticated investors to be wary of reliance on partial governmental ownership.

The most satisfactory situation would be one whereby rates are awarded on the basis of a predefined formula which is capable of being applied objectively, with the basis being set out in the company's License. If the privatization route selected is to seek investors who will take a controlling interest, it will be necessary for the GOP to devise a means of providing KESC with a ratemaking process that inspires long-term confidence.

7. Collection of accounts receivable

As mentioned previously, KESC is in default of a loan covenant that requires a satisfactory and sustainable plan for the reduction of receivables from government agencies and enterprises to be put into effect. The consequence of this, the inability to obtain critical funding for essential

projects, will be of prime concern to investors. Of course it is also critically important to the smooth operations of KESC that it should collect receivables when due.

In an effort to assist KESC in recovering its receivables, the GOP developed a procedure by which KESC would contact all the agencies with outstanding bills to settle accounts within a week. In cases where this approach was not successful, the matters were to be brought to the attention of the Secretary of the Ministry of Water and Power who would convene a meeting with KESC and the agency to reach an agreement on the reconciliation of the account within a week. The matter would then be turned over to the National Adjuster within four weeks who would decide the case within three months. If all these remedies failed, KESC would be entitled to disconnect the agency with the exception of KWSB and other emergency services.[27]

In December 1991, KESC approached the National Adjuster requesting an adjustment at the source to offset the outstanding bills of the Federal Government. In turn, the National Adjuster issued notices to the Federal Government to reconcile with KESC within a week. If this deadline was not met, the National Adjuster would contact KESC and the Departments directly. This process is expected to be completed within three months.[28]

In the case of the outstanding receivables of the Provincial Government, the National Adjuster recommended that the electricity duties withheld from the Sindh Government by KESC be offset against receivables owed to KESC. This adjustment occurred until February 1991 when the Sindh Government put an end to the practice and adjustments after February 1991 have not been made. It is not clear that KESC has any legal authority to withhold these duties.

8. Unrecorded liabilities

a. Octroi and land rent

A claim of Rs. 992,000,000 for octroi on electricity "imported" into the service area retroactive to 1982 has been made by the Sindh Government. This and another claim for land rent are being contested in the legal system by KESC. Although these claims appear weak, they must nevertheless be resolved prior to a share offer. Shareholders have not been notified of this claim as it is not mentioned in the current annual report.

b. Zakat

[27]In an effort to reduce the arrears of KWSB, the GOP has decided that the outstanding electricity bills of KWSB for the period before July 1, 1991 and the charges for FY 1991-1992 would be split equally and paid by the Federal Government and the Sindh Government. This arrangement is awaiting approval from the Sindh Government.

[28]From the current date, there is another month for this to take place.

The notes to the financial statements indicate that no provision has been made in respect of the Zakat as the amount cannot be quantified. In discussions with the company's external auditors we were informed that the amount involved, if any, would in all likelihood be immaterial.

E. Technical Factors

1. Market acceptance

Market acceptance addresses the ability to place share offerings in the market. The greater the level of market acceptance, the greater the chances for quick sale at good prices. This is directly related to investor perceptions not only of past trading performance of the share, but also of the overall prospects of the company.

In reviewing the trading activity of KESC shares in the past six months, we have found that the price of a KESC share has recently risen to as high as Rs. 56 and is now trading at Rs. 39.5[29], this decline being generally attributed to the decline in general market conditions. However, market professionals have indicated that the increase in the price was in expectation of a 30% stock dividend and the price declined on the news that this is only going to be 12.5%, leading to the conclusion that the "run up" in the price was artificial and not due to any fundamental perception of the quality of the share.[30]

Our interviews with members of the investment community indicated that knowledge of KESC's labor and collection problems was widespread and it is no secret that the Asian Development Bank has refused further funding. The market professionals feel that there is great scope for efficiency improvements which could be implemented by commercially-oriented controlling investors and if a clear shift in control from GOP to the private sector was indicated there would be increased acceptance of the share by the market.

2. Absorptive capacity of the market

As is the case with market acceptance, the absorptive capacity of the market is critical in assess the feasibility of conducting a share offering and analyzing its chances of success. Assessing the absorptive capacity of the market is especially significant in the case of developing countries where markets are generally thin and underdeveloped.

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[29]As of February 10, 1992.

[30]As in the case of stock markets in some other developing countries, the dilution caused by stock dividends is not fully adjusted by the market. Therefore, the more sophisticated investors in these markets perceive stock dividends as being beneficial. This is even more true of the Pakistan market where there is said to be a general shortage of shares.

In the case of Pakistan, market activity in late 1991 and early 1992 has been characterized by a number of new issues, all of which have been massively oversubscribed. In the most successful case, that of the Askari Commercial Bank offer in February 1992, Rs. 2,700 million in applications were received for this Rs. 300 million offer from some 400,000 applicants. This transaction, with qualifications, could be used to demonstrate the absorptive capacity of the market. Another indicator that could be used is the fact that about Rs. 4,000 million is now "tied up" in the several issues in process according to informed sources.

The principal qualification that applies in the use of these indicators relates to the high expectation that recent issues would be oversubscribed, given their relatively small size, possibly leading to a scarcity of shares and an improvement in the share price in early trading in the after-market. In all cases, this has occurred and the appreciation has been as high as 400%. However, this expectation would not hold true in the case of a very large offer such as may be the case for KESC. The expectation of a rapid price increase would also not hold true unless the GOP was prepared to substantially discount the share from the market price, which is unlikely given the political risk associated with such an action.

IV. CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

Based on our discussions with market professionals in Karachi, our other interviews and document reviews and our own experiences in structuring share sales and privatization, we have concluded that in the particular case of KESC there are four prerequisites applicable to any KESC share offering.[31] These prerequisites are:

- Developing a "prospectus";
- Addressing the areas of concern identified in Section III.C.3 ("Quality of the KESC Shares") of this report;
- Shifting management control to the private sector prior to or simultaneously with the offer; and
- Protecting the ability of the GOP to implement its overall strategy for the development of the energy sector.

1. Developing a "prospectus"

Under Section 62 of the Companies Ordinance, subsection (1),

> "No person who holds more than ten percent of the shares or debentures of a company shall offer for sale to the public any share or debenture of the company held by him except with the approval of the Authority."[32]

And under subsection (2) of Section 62,

> "Any document by which an offer for sale to the public is made by any such person as is referred to in sub-section (1) shall, for all purposes, be deemed to be a prospectus issued by a company.."

The subsection goes on to state that all enactments and rules of law relating to prospectuses will apply. We confirmed with the CLA officials and legal practitioners that any of the present owners of more than 10% of the KESC shares, including NIT, would be subject to Section 62(1).

[31] except the strategy by which periodic sales of KESC shares may be made to the market through brokers.

[32] The "Authority" is defined as the Corporate Law Authority in the Ordinance.

2. Addressing areas of concern

In Section III.D.3 we identified several fundamental weaknesses in the quality of the KESC share, including the Managing Agency arrangement, the uncorrected technical defaults of loans which have led to a denial of new finance, the dividend restriction which exists while subsidies continue, the reliance of KESC on those very subsidies, the confused accounting policies, the potential liabilities for octroi, land rent, Zakat and the Gratuity Scheme, and the lack of a credible ratemaking process. No large equity investment or investment by sophisticated investors will be forthcoming unless these weaknesses are remedied.

3. Shifting control prior to or simultaneously with the offer

Based on our interviews, we have formed the opinion that unless such an offer is accompanied by at least a firm undertaking and action plan towards shifting control of KESC to the private sector, the offer will have only limited success, even if there is a guaranteed dividend.[33] Since the GOP has no previous history of reneging on other similar commitments, it is believed by a small minority of those we interviewed that an undertaking from the GOP to transfer control will provide sufficient comfort. However, most market professionals were concerned that there is an unacceptable risk that, despite its best intentions, the GOP may not be unable to deliver on such a promise because of political conditions or a change in administration.

4. Protecting GOP strategy for the development of the Energy sector

At present, there is no official strategy for the privatization of the energy sector in Pakistan, but one is under consideration. The challenge is to ensure that the privatization of KESC can be structured in such a way as to be attractive to investors while still leaving the GOP's options open to require that the structure of KESC will, when required, conform with a national plan. We believe that this can be accomplished by an amendment to KESC's Licenses prior to privatization which would allow the GOP to direct that there be such operational and corporate changes from time to time as will better enable the achievement of national policy in such a way that the financial interests of the shareholders are not adversely affected. As the License conditions would be summarized and explained in the prospectus and be a document for inspection, the shareholders would make their investment in the full knowledge of the possibility of a change.

However, the best approaches would be ones in which the changes are implemented prior to the privatization of KESC or a policy decision is taken on the part of the GOP to implement such changes. These approaches have the limitation of requiring lengthy implementation periods and

[33] The case of Pakistan International Airlines was mentioned in this context, where the share fell in the after-market by 25% despite a Government guaranteed dividend when a minority interest was sold without a plan for a change in management control.

may delay the privatization process for a considerable length of time, so we will not include this in our suggested action plan.

As discussed in Section II of this report, there does not appear to be any technical reason why the restructuring of KESC and WAPDA must occur simultaneously. If KESC was not restructured in keeping with the proposed strategy, the company would appear as a generator to the system when it had surplus power and as a large industrial or distribution entity when its generation was insufficient. A more detailed analysis of the role of KESC in the privatization of WAPDA is beyond the scope of this study. However, one should be conducted as early as possible, as soon as a privatization plan for WAPDA is adopted by the GOP.

B. Alternative Share Offer Structures

Based on our analyses, we are recommending that the following alternative strategies be considered by the GOP in structuring a KESC share offering.

1. Sale of KESC shares on the market through brokers

Sales to the market from time to time through the stock exchanges would not be considered as an offer for sale to the public and thus not require a prospectus. For the sake of completeness we should also point out that, though Section 53 subsections (8)(a) and (8)(b) indicate that prospectuses are not required for rights issues, even renounceable rights issues, an offer to existing shareholders does require a prospectus per Section 65 if it is intended that others will also participate as applicants.[34]

If small amounts are sold periodically to the market there would be no immediate need to address the weaknesses in KESC discussed earlier nor to hold out the promise of an impending shift of control. As is the case with the prospectus, it will only be possible to escape having to improve the attractiveness of the KESC share if the shares are gradually released into the market in small amounts without adequate information to small, unsophisticated investors or speculators through brokers. Taking in consideration the magnitude of KESC's problems, such a strategy would not be considered ethical practice and the GOP should be setting the standard in this respect.

If this strategy was implemented, there would be rumors before long to the effect that the GOP was selling to the market which could depress the price. Given the current market, a very large sell order (of more than say 3%) would most likely depress the market price of the share.

We do not consider this strategy a viable one for the reasons discussed above.

[34] A renounceable right is one whereby the right is assignable to another person.

2. Sale of KESC minority shareholding to the general public through a public offer

In the case of KESC the sale of about 18% of the equity will represent a large offering in the context of the Pakistan equity market, being worth about Rs. 800 million at the current market price.[35] As discussed previously, the conditions giving rise to the success of the Askari Bank offer (the expectation of a rapid after market price increase and a shortage of shares) are not present in the case of KESC. The outcome of the Muslim Commercial Bank (MCB), where the price is at a substantial premium and the Price/Earnings ratio of 20 is high, will be closer to the outcome of a KESC offer under this alternative, with qualifications.[36]

If a public offer were to be made without additional changes, the share price would have to be heavily discounted (by more than 25%) from the current market price. Since the GOP has other options, the sale of KESC shares at discounted prices would be criticized.[37]

The time needed for the formulation of an action plan to shift control and correct KESC's problems, including obtaining all relevant GOP approvals will take as much time under this option as it would under the others discussed below. Therefore, since the effort and time required are about the same and the benefits are less, unless there are compelling reasons for there to be an early sale of part of KESC, we would not recommend the sale of a further amount which is smaller than the amount needed to shift management control.

3. Partial private sale (placement) to transfer management control followed by a public share offer (MCB model)

The MCB model could be considered as a possible model to be followed in privatizing KESC. Under this model, there was an initial private placement and transfer of management, followed by a public share offer.

In April 1991, 26% of the MCB equity was sold by the GOP to a group of local investors known as the "National Group" on the basis of a competitive bidding process during which

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[35]The Askari Bank offering was for Rs 600 million and the Muslim Commercial Bank (MCB) offering now in process is for Rs. 808 million.

[36]In the case of MCB, management control was shifted nine months before the public share offer. If a KESC public offer of a small amount of shares were to be accomplished without the benefit of prior management change, the outcome of even the MCB offer would not be representative of the receptiveness of the market to a KESC offer where the GOP was to shift control later.

[37] Changes here would include the actual shift in management control or a believable promise to implement such a shift with a specific action plan, including a plan to improve KESC's performance.

management control was transferred to the Group under an agreement that restricted the Group from disposing of any of the shares acquired in the private placement until April 1994. The shift of management was effected by the GOP vesting management in the Board of Directors by a Notification under the Banking Companies Ordinance with the Chief Executive and twelve Directors representing the National Group and nine Directors representing the Government.[38]

Problems related to the initial placement are instructive. On December 15, 1990, the GOP requested bids for the 26% of MCB and the bestowal of control. The deadline for submission of the bids was December 26, 1990 and by January 9, 1991 a letter of intent was issued to the National Group. An injunction obtained by a thwarted bidder (Tawakel), put the matter before the courts by January 16, 1991 and it was not until April 9, 1991 that GOP was able to complete the placement. The next hurdle was imposed by the MCB Punjab Workers Union which tied up the next phase of the transaction until February 1992 because of its desire to obtain a shareholding.[39]

In February 1992, an offer was made to the public for 26% of the equity at a price of Rs. 56 per share with the following key elements:

- The National Group has underwritten the entire offer for no fee or commission;
- Voting of shares after the offering will be proportionate to the shareholdings of the shareholders;
- The Group has the option to purchase additional shares from the GOP's 49% residual holding, at the Rs. 56 per share offer price to bring its holdings up to 50% if its holdings are less after the completion of the offer.[40]

The advantage of this is that there is no question that control can shift conclusively to the private sector following the offer as the National Group will be able, by one device or another (either by getting additional shares as underwriters if the offer is not fully taken up or by exercising its option), to have a 51% voting majority.

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[38]Notification 14 Bkg. IV/90-740 dated 8 April 1991.

[39]Under the current offer for sale, employees are given a priority entitlement of 10% of the offer (5% of the company) at full cost and on no special terms.

[40]Section 14 of the prospectus discloses this option but does not mention a time limit. Therefore, the option can be exercised at any time, but only in respect of the shortfall following the offer. It is assumed that the National Group would not be permitted to sell some of its holdings to the market at a higher price and buy an equivalent amount back from GOP at the offer price at some future date.

However, there are disadvantages associated with this structure as follows:

- A "one-on-one" sale such as the initial sale of 26% to the National Group in April 1991 provides fertile ground for allegations of underpricing and collusion;

- There is less than usual grounds for the expectation of a meaningful increase in the after-market because:

  -- The premium is very high as is the Price/Earnings ratio with the price not being perceived as significant bargain; and

  -- The National Group can obtain a majority holding without buying in the after-market because of its option to buy additional shares directly from the GOP's remaining 49% interest.

However, it is expected that the offer will be fully taken up and over applied for because the "breakup value" per the financial statements does not reflect current valuations. It is further expected that demand in the after-market will be provided by foreign funds.

Before making a final judgement as to whether the MCB model could be considered for KESC, we believe it would be prudent to await an analysis of the outcome of the current MCB offer which should be known by February 29, 1992 (10 days after the close of the list on February 19, 1992) and the early performance of the after-market. If the response to the offer is lukewarm and the price does not appreciate in the after-market, the use of a similar model for KESC will clearly not be well received by the market. If the offer is successful it is still not conclusive proof that this is the right model for KESC as the market at present is particularly receptive to banks and there are deficiencies in the offer which could--and should be avoided in a KESC offer.

A clear advantage of the MCB model over the sale of a minority interest to the public at large is that reliance would not have to be placed on a promise that control would be shifted as control would have been in fact transferred before the public offer.

To avoid a repetition of the litigation problems which arose in regard to the MCB offer, the following two changes should be considered:

- **Avoid placing GOP in the position of selecting the management group**

A placement with a group of financial institutions should be done instead of committing the shares to a management group. Placing with institutions is a normal market operation and should not give rise to criticism, especially as any interested institution can participate. The institutions will then either select a management group or sell their shares to such a group, in their own interest.

- **Include employees in the offering from the outset**

There are approximately 14,000 employees of KESC who in FY 1991 earned Rs. 1.183 billion for an average of Rs. 84,500 per annum.[41] In 1990 the Muslim Commercial Bank had some 13,000 employees earning Rs. 987 million, or an average of Rs.76,000 each. [42]. The value of shares reserved for employees in the MCB offer was Rs. 80 million, (1.4 million shares at Rs. 56 each) or Rs. 6,153 per employee equivalent to about 125 shares each. The equivalent figures for KESC would be Rs. 7,000 worth of reserved shares (at the current market about 200 shares) each. In this way, 2,800,000 shares could be reserved for KESC employees representing about 2.5% of the equity. In the case of MCB the employee reserved shares represented 5% of the equity.

A possible approach to structuring employee participation which would be popular would be one by which employees could each be entitled to a token number of free shares, a further amount of shares at a 50% discount and more at a 10% discount. In addition, a further amount of fully priced shares could be reserved. The time at which employees would have to pay could be on terms more favorable than those offered to the general public. Each employee would have the same entitlement regardless of seniority. In return for the discounts and the easy payment plan, employees would be prohibited from trading their shares on the market but instead be allowed to trade them on an internal market.[43] Since not all of the entitlements would be utilized, some shares would remain in the employee pool which would not be allocated. These should be available within a defined time frame to be taken up by employees who wish to do so.[44] This method has been used with great success in other privatizations which we have structured. If an easy payment plan is permitted, the percentage of shares reserved for employees could be as high as 7.5% of the equity (3 months pay at a share price of Rs. 30).

4. <u>Sale of a large offer to the public without a private sale (placement)</u>

If the GOP were to make an offer that was sufficiently large as to permit a management group to emerge through purchases in the after-market, there are indications in the market that GOP could make the offer successfully at a price in excess of the current market price under certain conditions.

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[41]Note 32 to the KESC 1991 Audited Accounts.

[42](Source: MCB February 1992 prospectus)

[43]If employees were able to trade on the open market immediately after the offer this would increase the supply of shares and depress the price.

[44]By this device, the requirements of the more senior employees can be accommodated whilst the appearances of an egalitarian scheme are preserved.

An offer of sufficient shares to bring the private sector holding to 50.1% would not be seen as sufficient, since the GOP holding at 49% would still represent the largest holding as a practical matter. A sale of sufficient shares to bring GOP's holding down to 24.9% or less is seen as the ideal strategy and the shares could probably then be sold at a substantial premium to the market, but only if there was known interest of some management group in obtaining a controlling interest.[45] Such a group could have the largest shareholding with 25% of the equity. Following the public offer, control would be bought in the after-market by those wishing to obtain control.

The principal risk associated with this strategy is that a group wishing control may not emerge. However, the after market could be very active if several groups fight for control.

5. Sale of large public offer simultaneously with a private sale (placement) to financial institutions.

Under this scenario, a group of financial institutions, rather than a management group, could be identified prior to the offer which undertakes to apply for 25.1% of the equity and the shares offered when combined with the 25.1% are sufficient to place 75.1% of the shares in the hands of the private sector and reduce the GOP's holding to 24.9%.[46] Both the private arrangement and the public offer would be done at the same time and at the same price, thus preempting any criticism of underpricing since all citizens would have the opportunity to buy at that price.

As a means of holding out some prospect for after-market appreciation in the share price, the private placement should be subject to a "clawback" of about 5% of the equity in the event of oversubscription which the core investors would have to acquire in the after-market thus creating a demand in that market.

Having considered all of the above scenarios but at present ignoring the problem of absorptive capacity of the market, we conclude that in principle, this strategy offers the best prospects for success.

The following exhibit contains a quick analysis of each of the scenarios discussed previously and the potential for success measures against evaluative criteria discussed earlier in Section III.

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[45]Under the Companies Ordinance a 75% majority of shares voted is required for the passage of some types of resolutions.

[46]For convenience and to avoid all doubt about the status of NIT, the 23.1% of the "GOP" holding retained could be held by NIT with the sale being made by the other GOP institutions.

Structure/Success Factor	Likelihood of full take up	Acceptable Price	Wide Distri-bution	Mgmt Control Shift
1. Sale of Shares through Brokers	Yes	No	No	No
2. Sale of Minority Shareholding to General Public by Prospectus	Yes	No	Yes	No
3. Private Placement and Transfer of Mgmt Control, Followed by Public Offer (MCB Model)	Yes	Yes	Yes	Yes
4. Sale of Large Offer to the General Public	Yes	No[47]	Yes	Yes
5. Sale of Large Offer Simultaneously with Private Placement	Yes	Yes	Yes	Yes

C. Absorptive Capacity of the Market

In making a final recommendation as to the strategy that should be adopted by the GOP, consideration must be given to the issue of the capacity of the market to absorb a KESC share offering relative to the recommended structure.

The size of the share offer using the strategy we recommend is considered very large. At the current market price, an offering of 68% would be Rs. 2.9 billion which is nearly four times larger than the MCB offer (the largest to date in Pakistan) and ten times the Askari Bank offer. [48] It is generally believed that if the structure is right, the GOP can sell the shares at a premium to the market, with estimates that the price could be as high as Rs. 60 per share under such circumstances. If this is correct, the offer could be as high as Rs. 4.4 billion.

[47]This would be "Yes" if installment payments were permitted. This is discussed below.

[48]108 million shares x 68% x Rs. 40 per share.

Market professionals do not favor the sale of the shares in tranches for a similar reason that they do not favor a sale before a decisive shift in management control which is that the GOP may not carry out, or be able to carry out, the further sales - perhaps even due to a change in administration.

This dilemma, where a shift in management control is a prerequisite but to do so requires a transaction beyond the ability of the market, can be overcome if GOP will permit payment for the shares to be made in installments such as is the common practice in major U.K. privatizations and as has been done for some of the smaller non-stock-market transactions in Pakistan.[49]

The mechanics of a public offer using installment payments is as follows:

- Applicants pay about 1/3 of the purchase price on application and receive interim certificates. The interim certificates are tradable on the stock exchange along with the fully paid shares. When an interim certificate is sold, the liability for the unpaid portion is transferred to the purchaser. A register is kept of the interim certificates which records all transfers.

- Either a financial institution/consortium pays the GOP for the unpaid portion and collects from the individual shareholders or the GOP collects the remaining installments directly from the shareholders.

- After payment of the second installment, the first interim certificates are cancelled and new certificates indicating that the second payment has been made are issued. Trading is then in second-installment-paid certificates.

- When the final installment is paid, the shares are transferred in the register of members.

- In the event of non-payment of an installment, the financial institution or GOP as the case may be can sell the related shares to the market and recover the amount due. It is a political decision whether the all the proceeds are kept (forfeiture) or whether any excess over the amount due is refunded to the purchaser either in whole or up to the amount previously paid.

- The holders of interim certificates are entitled to vote the shares and to receive dividends by virtue of the installment agreement.

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[49]This does not contradict the Companies Ordinance which, in Section 91, prohibits a company from <u>issuing</u> partly paid shares. In this case one shareholder would be merely selling its shares to others. KESC would not be issuing shares.

Such offers prove very attractive because of the leverage obtained by the successful applicants. An increase in the price of the fully paid share provides a much larger return on the investment in a partly paid share.

The difficulty with this mechanism is its complexity and the need for accounting for collections. However, in view of the risk that such a large offer would not be fully taken up, we believe that this approach will be essential if alternative 4 and to a lesser extent if alternative 5 (as discussed in Section B) were to be adopted.

D. Discussion with the Corporate Law Authority ("CLA")

During our meeting with the Chairman of the CLA to discuss our preliminary conclusion as to the structure of the offer we learned that:

- No shares being sold in a public offer can be partly paid, even if the share offer was not a new issue by a listed company and merely represented the sale by one shareholder to another. Therefore the installment method will not be permitted.

- An offer of 68% was too large for the market to absorb (unless installment payments were to be allowed).

- All applicants including employees must be offered the same terms in a public offer. Therefore there can be no discounting unless the employee offer is done either before or after the public offer. In no circumstances may the employees be given terms for payment - payment must be in cash at the time of application.

The Chairman indicated that these matters were only recently under active consideration and the consensus was the same as the positions outlined above. Furthermore, there also appears to be a need at present to keep matters as simple as possible until the processing capabilities of brokers' back offices and registrars is improved since the experience of dealing with partly paid shares in the past has been discouraging.

Since these matters have only recently been considered by the CLA we do not believe it will be productive to seek to influence the CLA to reconsider its position on these matters at this time. However, we do think it would be worth pressing the case for the employee share scheme to include payment terms, particularly as those shares will not be traded on the stock exchange until they are paid for in full.[50]

[50]In the meantime, they would be traded on an internal market administered by the Trustees of the Scheme.

As a result of the detailed consideration given to all of the above factors, we are forced to the conclusion that by default the MCB model discussed above offers the best solution to reconcile the disparate needs of GOP objectives and the special conditions relating to the equity market in Pakistan at this time. In the next section we set out an action plan for conducting the share offer.

E. Recommended Action Plan for Conduct of the Share Offer

The following is a suggested plan for the implementation of a KESC share offer based on our recommended strategy for structuring the share offering.

PHASE 1 - OBTAIN APPROVAL OF THE PLAN FROM THE GOP

After a review and modification of this report it should be submitted to the political directorate for approval.

PHASE 2 - SELECT TASK FORCE TO COORDINATE THE PROJECT

The Task Force should consist of the Secretary, Ministry of Water and Power (Chairman), a representative of the CLA, a senior corporate lawyer, a senior Chartered Accountant and an investment banker familiar with the Pakistan market. A full-time executive/adviser, probably under contract, with secretarial staff and an assistant should also be engaged to support the Task Force.

PHASE 3 - PREPARE KESC FOR FURTHER PRIVATIZATION

There are five main tasks that must be accomplished in this phase, all of which may be carried out simultaneously. These are:

1. Preparatory legal work

a. Amendments to the Memorandum and Articles of KESC

The shareholding of KESC at this stage would be as follows:

Private	7%
NIT	23%
Other GOP	70%

The Amendments required are such as would enable a shareholder group with less than an absolute majority to be able to exercise management control of KESC for an interim period,

with a reversion to normal voting rights for all shareholders following the public share offer and the expiration of the option mentioned in Phase 5 below.

Alternatively, this could be effected by preparing a draft shareholders' agreement by which the GOP shareholders would agree to support nominations for directors made by the future investor/management group as long as GOP remains a shareholder.

b. Amendments to the Licenses

The Licenses will give the GOP the right to require KESC to conform to national policy from time to time and incorporate a formula or set of procedures to provide assurance that shareholders will not be adversely affected in the process. This will provide the GOP with flexibility to implement strategy from time to time including the strategy which is currently under review.

A ratemaking procedure should also be established which is fair to investors and consumers and which provides incentives for efficient operations. It should be noted here that this is a task which will take considerable time and technical input to complete.

In view of the approaching date whereby the provincial government can by KESC's undertaking in 2003, consideration should be given to issuing a new license so that the option does not arise until 2042.

2. Improve KESC's accounts receivable and payable position

The settlement of outstanding debts and disputes and the reinstatement of the ADB funding facility will be the objective of this task. The Sindh Octroi and Land Rent issues should also be settled.

3. Eliminate all subsidies to KESC so that dividends may be resumed and ensure that KESC can earn sufficient revenues in replacement of the subsidies lost

We have calculated that the subsidies received by KESC in FY 1990-1991 were to be the equivalent to 20% of the revenue earned from electricity sales. The GOP has already made a commitment to remove subsidies. Furthermore, the ADB has prohibited the payment of cash dividends by KESC until this is accomplished.

4. Review the accounting principles employed by KESC and possibly restate the financial statements

There are a number of accounting principles in use that may not stand the scrutiny of large, sophisticated investors. Prior to seeking such investment, the appropriateness of these should

be reviewed in relation to internationally accepted accounting standards and if necessary the financial statements should be restated on the basis of appropriate principles.

5. Structure an employee share purchase scheme

A scheme for allowing participation of employees to occur at the same time as the placement to the management group should be prepared along the lines set out in Section IV.B.5 of this report. A Trust should be established to manage the scheme.

PHASE 4 - SEEK AN INVESTOR/MANAGEMENT GROUP AND SIGN AGREEMENT

Having appropriately "packaged" KESC, proposals should be sought from investors for the purchase of a substantial block of the equity (about 26%) from the GOP and the assumption of management control. Bids should be required to demonstrate management capability, in some cases perhaps by including a foreign management team on a long-term contract basis. The investor group would have to commit to a long-term investment (in the case of the National Group and Muslim Commercial Bank this was for three years). A binding agreement secured by an appropriate performance guarantee should be obtained.

PHASE 5 - SHARE SALES

- To employees

The employee share scheme should be announced at the same time as the agreement with the management group and implemented as soon as possible thereafter or at the same time as the sale of the shares to the management group. By implementing the employee scheme prior to the public offer it will be possible to discount the shares under the CLA rules. Moreover, such a move should preempt the employees from taking action similar to the action taken by the MCB employees. As discussed earlier, the employee share sale will represent about 2% of the equity (which could be increased comfortably to 7.5% under certain conditions) and the shareholding after this sale will be:

Private	7%
Employees	2%
NIT	23%
Other GOP	68%

- To the Management Group

The share sale to the Management Group of 26% of the equity would then be effected in accordance with the agreement reached in Phase 4 above. By virtue of the changes to the Memorandum and Articles of Association and the change of some of the directors (discussed in Section III of this report) the Management Group of investors would take control of KESC.[51]

The shareholdings at this point would be:

Private	7%
Employees	2%
Management	26%
NIT	23%
Other GOP	42%

- To the public at large

The GOP would sell a quantity of shares, for example an additional 25%, (depending on the absorptive capacity of the market at the time), to the public. This will leave GOP (excluding NIT) with some 17% of the equity. The Management Group can be given an option with a time limit to purchase the 17% non-NIT holding at a price to be negotiated when the option agreement is signed. If the Management Group does not exercise the option by a particular date, GOP will be free to dispose of the shares to the market and the clauses in the Articles or in the shareholders agreement which guarantee management control would terminate.

	Before the option is exercised	After the option is exercised
Private	32%	32%
Employees	2%	2%
Management	26%	43%
NIT	23%	23%
Other GOP	17%	0%

[51]To remove directors the management shareholders need 30.6% of the votes. The GOP and NIT would have to cooperate for the appointment and removal of the directors.

The Management Group will have a clear incentive to acquire a further 7% of the shares to have a controlling interest and this will ensure that the price of the share has support for a reasonable period.

V. SUGGESTED TERMS OF REFERENCE (TOR) FOR PRIVATIZATION STUDY OF KESC

A. Scope of Work

Our original scope of work for this engagement included the development of suggested terms of reference (TOR) for the conduct of a full privatization study for KESC. However, we believe that our proposed strategy which has been discussed in the previous section will achieve the full privatization of KESC. Therefore, we are proposing that our Recommended Action Plan for the Conduct of the Share Offer serve as the Scope of Work for such a study should the GOP feel that this additional step is necessary.

As part of our proposed action plan, we have recommended the appointment of a task force to coordinate the privatization of KESC through a share offering. We anticipate that the principal work of the Task Force will be addressing the tasks that should be accomplished before the offering described in Sections III and IV and implementing Phases 3 through 5 of the Action Plan.

The Task Force would require technical assistance in accomplishing its tasks, specifically in the legal, accounting and utility economics areas. This technical assistance team should be led by a Chief of Party who will serve as the principal liaison between the Task Force and the team and have overall responsibility for the management of the team.

B. Qualifications of Proposed Team

1. Chief of Party

This individual will coordinate the work of the specialist consultants and monitor the progress of the activities which need to be taken by the GOP such as resolving existing disputes concerning accounts receivable, electricity duties, octroi and land rent. He will ensure that adequate arrangements are made for the conduct of the share offer in accordance with the GOP objectives, develop the evaluative criteria by which the management group is selected and establish the bidding process. This consultant will work closely with the Task Force to implement the share offering strategy selected by the GOP.

The Chief of Party should have five to ten years experience in the areas of investment banking especially in structuring and implementing share offerings in developing countries as they relate to privatization. Previous experience in raising financing for energy enterprises in developing countries as well as experience in advising Government Agencies in this regard would be preferred. An M.B.A. or equivalent training in the areas of accounting or economics should be required.

2. Legal Advisor

The legal advisor will be responsible for drafting the amendments to the memorandum and articles of KESC in accordance with the issues discussed in Section III.D of the report and Phase 3 of the proposed action plan related to the changes in management structure and the drafting of a new license. In addition, this advisor will be responsible for assisting the GOP in the drafting of the prospectus.

The legal advisor should have previous experience (not less than five years) in energy law and regulation and in structuring share offerings in developing countries, especially as they relate to privatization. First hand knowledge of Pakistani law would be preferred.

3. Utility Economists

These team members will be responsible for identifying the most appropriate ratemaking structure for the new entity and establishing the initial rates to be charged by a privatized KESC in accordance with the discussions set out in Section III.D.3.f. of this report. This work should be conducted in close coordination with WAPDA and other entities in the sector and with the Legal Advisor in the drafting of the new license.

The utility economists should have advanced degrees in economics or finance and not less than five years of experience in designing, analyzing and implementing tariff structures either in the U.S., U.K. or in developing countries. In addition, the economists should have a strong working knowledge of regulatory frameworks pertaining to the power subsectors in the U.S. and the U.K. Previous experience in designing and implementing ratemaking processes for newly-privatized energy sectors in developing countries would be preferred.

4. Accountants

In the event that it is determined that a review of KESC's accounting policies in keeping with internationally accepted accounting standards is necessary, accounting professionals should be included in this team. These individuals will be responsible for conducting a
a thorough review of the appropriateness of the accounting principles utilized by KESC, establishing new policies and restating the financial statements as necessary so that they are suitable for inclusion in a prospectus.

This task can be performed by a local accounting firm that is affiliated with one of the international accounting firms to ensure that internationally accepted accounting principles are used in the review of KESC's accounting policies and in the establishment of new policies.