

Strong Electricity Regulatory Commission is More Urgent than Unbundling NEA

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Based on your observation over these five years, what do you think are the major causes for the lethargy in Nepal's hydropower development?

There are some very capable and committed professionals in the government and in the hydropower industry in Nepal. I have had the opportunity to know and work with many of these people in the last five years. One key issue that had plagued the sector is the slow and often frustrating pace and non-transparent decision-making process of the government. The bureaucracy has been unable to make timely decisions because even simple decisions had to be signed only at the highest levels of the government. Political instability and changing priorities of different governments have resulted in "almost-ready" decisions being rehashed over and over again. There appears to be a strong perception that there is no positive side to making a good decision; only a reprimand, or worse, if there is any error or even a perception of error in a decision, particularly if the decision was likely to be controversial. Sometimes, the press blows up issues with second-guesses and 20/20 hindsight, without any relevant investigation or analysis which delays the process even further. Nevertheless, some excellent efforts have been made in the last several years and they are awaiting final approvals and hopefully will see the light of day soon.

How changed is the situation now after the political change?

Even though the politics has changed, there is still a lot of uncertainty about the interim government and the elections. But now decisions are coming through, a bit slow but certainly a very welcome change. For example: As you know, two major international seminars held in 2006 on hydropower opportunities in Nepal created enormous private sector interest for large investment. A number of applications for licenses were made for the 300 MW Upper Karnali and 400 MW Arun III projects starting in June last year. The government took some time but made a decision to request formal proposals to develop these projects in October. The proposals were received in January and a technical committee was appointed to evaluate the proposals. The press has reported the results of the Committee's analysis and suggestions. Hopefully, a final decision to award the licenses will be made soon.

Competitive bids for the 30 MW Kabela project were received in January this year and technical proposals were evaluated in February. The government opened the price proposals in March and completed the evaluation in April. I understand a decision is expected shortly. The NEA has signed a MOU with an Indian entrepreneur for developing transmission line links with India. Yes, things have improved.

In order to improve the decision making process, the government should implement the philosophy that "no-decision" may be as bad as or worse than a bad-decision and that the staff would be held responsible. It should delegate decision-making authority to the appropriate lowest levels of the government to facilitate timely action. The government should promote the policy that mistakes are not uncommon and that one should learn from them rather than "do nothing" to avoid possible mistakes.

Donors are pressing the government for unbundling the NEA. But critics point out that the NEA was bundled in the first place on the recommendation of the same donors. What is the genesis of this policy shift of the donors?

A fundamental reason for any such policy change or reform is a valid need for such change. Generally, the need for reform is based on real or perceived ineffective or inefficient operations, or if the entity concerned is unable to meet

its mandate because of changed circumstances. When years ago, the World Bank said 'bundle them all together', there were too many small electric companies and by aggregating them, one could get the benefit of the economy of scale. I am sure some of those advantages were realized with the formation of NEA. Certainly, the almost half a billion dollar private investment in the sector would not have come if it were not a consolidated NEA as the buyer of electricity.

In Nepal, we have experienced and will continue to experience significant power shortage for sometime and there is almost no investment from the government or multi-lateral donors in the sector to meet domestic demand for electricity. Our tariff is among the highest in this part of the world and there is significant second-guessing in the press and everywhere about some of NEA's past decisions. All this has resulted in a call to unbundle the NEA for better accountability and transparency of operation. It is necessary to find out which parts of the utility are working well and which are not, so that one can focus on improving performance.

Unbundling is a process which may be carried out in steps. Nepal may do this in two steps by first commercializing NEA's component parts – generation, transmission, distribution, and support services and then, privatize each of these entities or may do all this in one-step to privatize the NEA directly into independent component companies.

Unbundling of state-owned utilities has occurred in India in a number of states in the recent past and has resulted in better performance in most states. However, such unbundling may not be necessary if the need does not exist or is only minor. Tamil Nadu in India has decided to stay with its vertically integrated utility and is doing well. Thailand has a government-owned generation/transmission company and two distribution companies which operate as commercial entities. Unbundling of a utility is not the "in-thing" to do. It is done only to address a genuine and established need.

Now that the unbundling of NEA seems to be put on hold due to the political situation, how is it going to affect private sector investment in hydropower development?

NEA's unbundling is a process for better performance of the utility and its components and the beneficiary will be the people of Nepal. It will not directly affect large private sector investment in the sector if the rules for entry for such investment are open, transparent, and competitive. Generally, large and long-term private sector investment will come in, if the rules and regulations are known and the mechanism for enforcement of rules is transparent and functional. The private sector needs an assurance that if one plays by the rules, then the outcomes would be predictable and the risk of large and long-term investments become manageable.

One of the first things we need in Nepal is an independent and strong Electricity Regulatory Commission which balances and protects the interests of all the stakeholders including the consumers, developers, investors, creditors, industries, government, and the general public. Such a commission provides a level playing field for all the stakeholders and ensures transparency in making large and difficult investment decisions. It also ensures that private investors will be treated in the same way as a government-owned utility when it comes to competition and operation in the sector.

The government is committed to set up the Nepal Electricity Regulatory Commission (NERC). I understand the NERC law, which we helped draft, is in its final stages towards legislation. It will take a year or so before the NERC becomes fully functional but the donors, World Bank and the ADB are all ready and committed to assist.

Though IRG was supportive of unbundling NEA, it was against the proposal to unbundle the existing private power companies. What was the logic?

Let me reiterate. I speak for myself and not for any entity. However, since you specifically brought IRG in the question, let me say this. It is not that IRG, or anyone else, is for unbundling the NEA but not for unbundling others. The fundamental purpose for any unbundling (or for that matter any reform) is, as I said earlier, to address a valid need. If a vertically integrated private power company is doing very well and selling power at a price that is half of what NEA charges, then further improvement in operations will likely be only marginal. In that case, it behooves to leave it alone, at least for the immediate future. However, if such a company has similar issues like the NEA and is unable to meet its mandate, a reform should be called for. An independent regulator of the sector would achieve precisely that.

The ultimate objective of unbundling NEA seems to be developing a power market in Nepal similar to the ones in Scandinavian countries. But there is skepticism about this idea looking at the nascent stage of overall economic development in Nepal. What is your perception?

I am not sure about your reference to Scandinavian countries since I am not familiar with their market operations. Let me talk about a power market in Nepal for domestic use and exports to its neighbors. At present, electricity accounts

or about 2 per cent of Nepal's energy consumption. About 85 per cent of energy comes from firewood, animal wastes, and agricultural wastes. As the energy use increases in the coming years and, if we don't change the energy use pattern, we may not have any forests left. We have to look for alternatives and see if our huge electricity potential can be developed to meet a greater portion of our future energy needs. This is a large, long-term undertaking for the country involving investments in tens of billions of dollars and requires significant foreign participation in generation, transmission, and distribution.

The existing power market in Nepal is small and is monopolistic. NEA is the sole buyer from all the generators. NEA also is the only seller to all grid-based consumers. We have to reach several million citizens who currently have no access to electricity. The government needs a plan to design the market in steps to meet its ultimate goal of "electricity for all" at a reasonable price.

One of the traditional means available to any country to finance its local expenditures is by increasing exports. India offers a great market now for electricity export from Nepal. The two countries are now in a better position than ever to make the cross-border trade happen. The government should think about creating a power trading entity, perhaps similar to PTC India, to initiate and manage cross-border power trade. Certainly, the NEA as a local utility is not mandated or equipped to perform trade.

If there is open competition, the market would become more efficient. We have IPPs in the generation sector. We have BPC as a private utility. The market should be opened up for competitive and transparent operation. There needs to be an independent regulator to facilitate the process.

International development agencies are talking of developing a South Asian regional power market by linking all the countries through a common power grid. How has the reception of this idea by the individual countries been? How remote is the possibility of actually setting up such a market?

In my view, a regional market for power is quite some time away. I think every country does look at what is important to meet its own goals first, certainly in the context of regional and international policies and protocols. If a country sees value in importing power from its neighbors, it will do so in its own interest. We have hydro, coal, and natural gas resources in the region and I am sure in the long run, the governments would come up with better utilization of these resources and equitable sharing of the benefits. If the Kyoto Protocol gets implemented and the industrialized and fast-developing countries commit to reducing their carbon emissions, carbon credits may go up significantly from the few dollars a ton to, maybe, \$25-30 a ton. Then Nepal's hydropower would be even more valuable.

SAARC countries should establish an energy think tank and have professional, educational and research institutions in individual countries work on the details to develop an energy plan that makes sense to the individual countries and the region and prepare a roadmap for its implementation. Initial work on these lines is already underway. National and regional commitment is crucial for the success of such plans.

In my opinion, a regional grid will materialize only on the basis of several successful bilateral arrangements. Bhutan and India have a good arrangement. Nepal is on its way for similar ties with India. I am sure the talks of the undersea transmission line between Sri Lanka and India will become a reality in the next several years. Cross-border power trade among Pakistan and Bangladesh with India would become reality soon. Bilateral arrangements become the corner stones for the regional working because they provide the experience with trading partners, mechanisms for improvement and dispute resolution. A regional grid based on mutually respectable and beneficial partnerships will simply fall into place.

At present, the government is mulling over a score of proposals from foreign investors for developing power projects on a number of rivers. What is your suggestion to the government while deciding on these proposals?

The decision should be based on what is best for the country. So we have to set clear criteria for the selection. The

three projects that the government has asked proposals for—the Upper Karnali, Arun III and Budi Gandaki—are primarily meant for export and hence one of the criteria for evaluation would be additional revenue a developer would pay over and above the mandated royalty payments. The government may look at other opportunities such as "free" equity to share in project benefits. Of course, care should be taken to manage potential liability arising from any equity position. The government has to assess the capability, experience, and track record of the bidders in successfully executing similar projects. A critical parameter to consider will be the overall schedule for project completion. These projects would entail investment of over one billion dollars and result in significant associated benefits to local and national infrastructure, commerce and industries, long-term high-paying jobs, and an annual

royalty payment on the order of \$100 million or more. I am certain the government committee has considered these and other aspects in its analysis and evaluation of the proposals.

There is a frequent complaint that the price of the power that NEA buys from IPPs is exorbitantly high. On the other hand the IPPs say one reason for this is the short license period at the end of which the project has to be handed over to the government for free. Can there be some reforms in this area?

Let us go to the basics: There is a demand for electricity and NEA is mandated to meet it. NEA has several options to meet this demand. It can build power plants; buy electricity from IPP plants; import from neighbors; or meet the demand by a combination of these options. In all cases, the bottom line for NEA's decision will be the overall cost of obtaining this energy, for sale to its customers.

In the past, the World Bank and the ADB used to finance entire hydropower project costs. This stopped around 1995. Some donor agencies continue providing such funds, such as for Kali Gandaki and Middle-Marsyangdi. The NEA has to "pay" the government for such financing at relatively high interest rates. NEA's tariff should allow it to generate sufficient funds from its operations for expanding its system. This is not quite the case. NEA states that one of the reasons for its poor financial health is the high cost of IPP energy purchase. There are several reasons contributing to NEA's high cost which include the above issues as well as system losses, theft, uncollectible charges, and operational issues.

Let us examine the question of high cost paid to the IPPs. Industry information is that Chilime has the highest tariff today, around nine cents per unit. Khimti and Bhote Koshi are paid around eight cents or thereabouts. Small power producers get around six cents on the average. The average cost of NEA's generation is estimated around five cents but the cost of a new plant addition by NEA is likely to be higher. NEA will buy from an IPP if the price is lower than its own cost of development or if it has no financing capability to develop its own project. When NEA signed the agreement seven years ago with Khimti and Bhote Koshi, I believe, it was looking at an unmet system demand of 100 MW and it had three options: (1) accept the power shortage and let the country's economy suffer, equivalent to 30-40 cents per unit; (2) use diesel generation at 12-15 cents per unit, or (3) purchase from the IPPs at six to seven cents. It chose what, in my view, was the best option and still continues so from a national view point. It has not done much for NEA's finances but it has certainly brought in large private investment in the country and is now a basis for a larger investment interest.

The government, learning from this experience, has conducted a competitive development process for the 30 MW Kabeli project, which I was intimately involved with. Newspaper reports suggest that the tariffs offered may be significantly lower than current price levels and that if an agreement was struck, such tariff may become a benchmark for future energy purchases from IPP plants.

Now to your question: It is true that that the projects have to be handed over free to the government at the end of the licence period and this would cause a small increase in tariff requirement for the IPPs. However, this is not significant considering the fact that most project financing analyses use an economic life of no more than 25-30 years. The government has, as part of addressing such issues, included in its new Electricity Act, provisions for a favorable treatment of interested IPPs for continued operation of the plant beyond its original license term, when the ownership transfers to the government.



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