IRG Discussion Forum

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Privatization in the Energy Sector

Washington-area professionals gathered on May 22 for the seventh session of the IRG Discussion Forum, "Privatization in the Energy Sector." Arun Banskota of El Paso Global Power and Shahid Javed Burki of EMP Financial Advisors discussed lessons from the past and predicted trends for the future at the roundtable, which was moderated by IRG Advisory Board Chairman Henri-Claude Bailly.

Rising economic growth and increasing demand for public services historically have spurred major investments in energy projects in developing countries. But today, economic indicators show that the current demand for energy services greatly exceeds the available supply. Addressing these growing energy investment needs will require foreign direct investment in developing and transition economies.

Two decades ago, many countries began to open their energy sectors to private investment as a means of alleviating energy shortages. The results have been mixed. In some countries private power investments have led to fiscal liabilities that produce macroeconomic imbalances. Privatization has also performed poorly when the government refuses to allow the tariff adjustments that make continued private participation profitable.

Past and Present

Private power is nothing new. By the late 1800s, many independent power generators operated freely in a robust marketplace. Monopolies began to emerge, and by the 1930s the current system of geographically defined utilities had essentially emerged.

In the 1980s and 1990s, privatization began to challenge those natural monopolies. California and Rhode Island were the first in the United States to challenge this setup and pass legislation that allowed people to choose their utility providers, and Pakistan became one of the first developing countries to implement a plan for independent power producers.

During the last 20 years, tens of billions of dollars have been invested in energy privatization—including $38.6 billion in 1997, the peak year of investment. The bulk of the dollars has been directed at Asia and the Pacific (for new projects) and Latin America and the Caribbean (for restructuring).

But since 1997, there has been a steady slowdown in the market as investors started rethinking the "gold rush" of the early 1990s. Economic contraction and highly publicized instances of corporate malfeasance (including Enron and the California energy crisis) have slowed the flow of foreign direct investment and the tolerance for risk. Meanwhile, a third of the world lacks any access to electricity, and demand continues to skyrocket even as resources stagnate.

IRG President Asif Shaikh; El Paso Global Power Managing Director Arun Banskota; IRG Advisory Board member Jeff Seabright; IRG Advisory Board Chairman Henri-Claude Bailly; and EMP-Financial Advisors CEO Shahid Javed Burki

China, for instance, has one of the fastest-growing markets; its electricity demand is increasing at

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an average of 10 percent a year. By some estimates, 200 million people may relocate from China's rural areas to its urban areas over the next 20 years, and the average income could reach two-thirds of the current U.S. average. This confluence of events would combine to create an economic mega-region along China's east coast, in need of the infrastructures that will support the massive population—including power.

Future

Developing countries offer intriguing opportunities for investors; power demand averages 10 percent annual growth, as opposed to developed country projections of 1–2 percent. In addition, electricity demand appears to be less volatile in developing countries than it can be in developed countries. For example, information technology drove power demand to 150 gigawatts in the United States in 2000–01; that demand had dropped a third by 2003. Power demand in developing countries, on the contrary, has remained fairly steady-around 20–35 gigawatts during the same period. This number is expected to grow. The result is a real need for more capacity in generation, transmission, and distribution facilities for electricity, and parallel developments in coal, natural gas, oil, and renewable resources. In China, for every 10 percent of growth in energy demand, the country requires an additional 40 megawatts of capacity. Foreign direct investment will have to play a role in meeting this demand.

In developing countries the perception of risk is much higher now than it was at the peak of private participation in infrastructure development in the late 1990s. In part due to the failure of "household name" companies, there is an increasing acknowledgment that high-cost energy is not sustainable. At the same time, investors have reduced commitments outside developed countries, the equity market has trained its focus on the United States and Europe, and the commercial debt market has virtually dried up.

What Lessons Have Been Learned?

As one of the first key steps, the governments of developing countries will need to reduce the risk that their current policies pose, including significantly enhancing transparency in government institutions, developing independent regulatory authorities that can set prices that are affordable and sustainable, creating closer links between customers who pay and jobs that are created by a reliable and clean energy supply, and building a host government climate that is conducive to economic growth. China has already received large investments, and demand continues to grow. India will likely see similar growth in population, wealth, and energy demand.

Dramatic increases in demand require solutions that attract foreign capital. Governments require policies that reflect the interests of investors and consumers. There is

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a tension between suppliers and consumers, and an absence of good regulatory systems that link price with demand.

Packages should be created that minimize risk for energy developers and offer consumers affordable services that match their incomes. If this can be done effectively, it is possible that there will be a second gold rush, as developers find that the need for more energy is as large as at any time in the past hundred years.

For More Information...

World Energy Council: www.worldenergycouncil.org

Public-Private Infrastructure Advisory Board: www.ppiaf.org

Alliance to Save Energy: www.ase.org

Organisation for Economic Co-operation and Development: www.oecd.org

U.S. Department of Energy, Energy Information Agency: www.eia.doe.gov

UN Development Programme energy practice: www.undp.org/energy/index.html

World Bank energy practice: www.worldbank.org/energy

Forum Feedback

- The lessons learned in Europe and Eurasia illustrate the importance of establishing a regulatory structure before privatization begins. Thus the World Bank has become increasingly engaged in establishing strong laws and regulations. USAID has consistently supported the growth of sustainable regulatory institutions to promote economic growth and raise living standards. Good progress has been made in countries including Chile, Malaysia, Mexico, and South Korea.

- Globally, corruption results in significant opposition to reform and restricts the progress of privatization. A sound political process reduces risk, but the private sector cannot be expected to build or rebuild public institutions. This will need to be accomplished by the host governments themselves, with the assistance of donor nations and multilateral organizations. Transparency in government institutions is a key measure of the ability to combat corruption; increased transparency in many developing countries would be required if foreign direct investment is to be attracted.

- Africa has the largest proportion of people unconnected to an electricity system. However, at the moment, Africa does not seem to be a priority for private power investments due to its lack of resources, absence of transparency, and generally weak institutions. For now, finance will have to flow to Africa from grants so that debt burdens aren't made bigger. Currently, Africa offers a qualitatively different developmental challenge than the rest of the world and, so, needs to be treated uniquely.

- There is a close link between the success of privatization and the degree of reform. If privatization is undertaken after serious institutional reform, then it is likely to be successful. Conversely, if reform has not taken place, then the results of privatization can be negative, making it difficult to return to negotiations.

- There is a sense that risk perception can be managed through guarantees and policies of consumer involvement. Ultimately, however, investors are concerned that their return be commensurate with their risk. Where there is a high risk, even if it is mitigated in part by consumer involvement, there will need to be a high reward for investment projects to go forward. These investors are competing not only for scarce capital, but also for other investment opportunities within their own organizations. The need to do what is best for shareholders requires a combination of high rewards and low risk. Even a strong social contract with consumers would not justify a return of only 10–12 percent.

About the IRG Discussion Forum

The IRG Discussion Forum is a monthly roundtable for the Washington-area policy community. Building on the Central Asia Speaker Series held at IRG in spring 2002, the Discussion Forum focuses on public and private sector issues affecting international development—agriculture, energy, sustainability. Each session is informal, and off the record; guest speakers and attendees are participating in a personal capacity.

With the Discussion Forum, IRG hopes to foster an environment for sharing experiences, exchanging ideas, and creating new approaches to development.

Henri-Claude Bailly, chairman of the IRG Advisory Board and senior advisor to the president, moderates the IRG Discussion Forum. Mr. Bailly is the former chairman and CEO of Hagler Bailly, an international management and consulting firm to the energy and utility industries. He is a director of the Alliance to Save Energy and a member of the Advisory Council of the Energy Future Coalition.

Schedule

Thursday, June 19	Energy Challenges: Security, Access, and the Environment

For more information, email discussionforum@irgltd.com or call International Resources Group at 202-289-0100.

International Resources Group (IRG) is an international professional services firm that helps governments, the private sector, communities, and households manage critical resources to build a cleaner, safer, and more prosperous world. Since its inception in 1978, IRG has completed more than 600 contracts in 120 countries, delivering high-quality, cost-effective services that promote positive economic growth, institutional and social change, and intelligent use of resources—human, physical, environmental, financial. IRG's ability to provide management, economic, and technical advice is enhanced by the diversity, cross-cultural experience, foreign language skills, and management capabilities of its expert staff, working from IRG's Washington, DC, headquarters and 20 offices around the world.