

Energy tariffs: increase the denominator

Last week, an MoU was signed between the government and 2002 policy IPPs to reduce the latter's guaranteed return on equity (ROE) and sharing of excess returns on operational and maintenance (O&M) expenses from contractual efficiencies. It is a landmark decision as it signals government's resolve to revise contracts with skewed investment incentive structure. It will also set the tone for adjusting contractual arrangements for other power generation projects.

Over the past few years, circular debt buildup was closing in on Rs35 billion per month, which has increased to Rs50 billion post-Covid. Any reduction in returns of power producers will reduce the need for a future tariff increase. However, gains in terms of tariff reduction are negligible, if any. For savings to reach a meaningful level, a similar exercise be repeated with government-owned projects and those falling under CPEC. Further, a meaningful tariff reduction requires that governance reforms must be extended to include energy distribution system.

Back in the 1990s, Pakistan's per capita power consumption was at par with Sub-Saharan African countries. It was thought that the country needed to add 100,000 MW in next 25 years to reach at par with Malaysia and the Philippines. Instead, we were only able to add around 20,000MW to the National grid. Even today when excess capacity exists, the country is far from reasonable levels of power consumption for a developing economy. Hence, not adding power should not be the consideration. Instead, the focus should be on expanding the power consumption pie.

The current discussion revolves around negotiation with power producers and bringing down distribution losses to lower the numerator. The tariff is computed by dividing cost of production and distribution over the number of units consumed. Working on the denominator (by increasing the number of units consumed) will lead to real gains.

Give the existing power producing capacity, system consumption can increase to 150 billion units (KWH) from existing 110-120 billion units. With new capacity coming up, consumption can reach 180 billion units by 2023. The variable cost is low in upcoming plants while the fixed cost component is higher. The country is paying higher fixed cost without taking benefit of lower variable cost. Consumption level, therefore, cannot be increased without removing grid constraints and making distribution utility companies efficient.

The government must bring marketing people in to tap the pent-up demand. Discos lack incentives for onboarding new customers. Industrial users are relying on captive power plants (CPPs). They plead for cheap gas from the government to run inefficient CPPs. These must be brought into the grid as well. Do direct wheeling where required. Long-term contracts must also be reached with industrial units. Similarly, transmission capacity also needs to increase. Funding is not the issue as loans from ADB have already been sanctioned for the purpose.

The government must also explore other avenues to increase the denominator such as bringing inefficient energy consumers to the grid. In Pakistan, 16 percent of country's energy needs are met by electricity, whereas 65 percent of energy consumption is solely relying on oil and gas. Some of these should be converted into electricity (power) for efficient usage. In domestic consumption, the load of heaters and geysers in winters should move from gas to electricity. The pricing must be right for creating incentives for domestic consumers to shift.

The other area is to shift transport burden from oil and gas to electricity. World is moving towards EV. In Pakistan, the auto lobby is advocating against global tailwinds. In a recently announced EV policy, there is no incentive for 4-wheelers. This must change. Public transport must move towards electric buses. Karachi urban transport should be EV based. Charging should be done in off-peak hours and renewable energy should be used for the purpose.

Power contracts renegotiation is off to a good start. But the government must look beyond traditional cost minimization lens to optimize energy supply and consumption in the country to achieve long-term growth.