POLICY FRAMEWORK AND PACKAGE OF INCENTIVES FOR PRIVATE SECTOR POWER GENERATION PROJECTS IN PAKISTAN

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GOVERNMENT OF PAKISTAN

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A. **INTRODUCTION**:

Presently the total installed capacity in the country is 10,800 MW. This capacity is insufficient to meet the demand on a year round basis, as such at different times of the year particularly during the period of low river flows, consumers have to be subjected to load shedding (forced power cuts). The magnitude of this shortage is around 2,000 MW during peak load hours. Electricity is available to only 40% of the population and per capita consumption of electricity per annum at 300 kWh is extremely low.

The system is characterized by a high degree of suppressed demand. Conservative projections for annual average increase in the demand are nearly 8% per annum for the next 25 years, which means that approximately 54,000 MW of additional generation capacity will be needed upto year 2018. Minimum annual additional capacity requirements are of the order of 900 MW in year 1994, increasing to 1,300 MW in year 2000 and 5,000 MW in year 2018.

Such an ambitious programme cannot be financed in the public sector due to ceilings on Public Sector Development Programme (PSDP), and resource mobilization in the private sector is essential for meeting these development targets.

Although a policy for setting up private sector BOO (Build-Own-Operate) power plants has been in effect in Pakistan since 1986, the pace of progress in this regard has remained slow. Major factors which have discouraged prospective investors include:

1. Protracted and detailed negotiations on technical & financial aspects of the projects leading to Power Purchase and Implementation Agreements, based on 18% IRR on Equity.

2. Sale price of electricity was not internationally competitive.

3. Lack of clarity about facilities and concessions available to investors in private power plants.

4. The regime of import charges was often subject to mis-interpretation and at the same time required the potential investor to arrange large sums of money upfront for making demands of custom duties and taxes etc.

In order to support the power development programme of the country for the Eighth Plan period (1993-98), a minimum estimated amount of Rs 102 billion, comprising Rs 86 billion in foreign currency and Rs 16 billion in local currency, would have to be raised in the private sector. The Government of Pakistan is keenly aware that resource mobilization on such a massive scale in the face of fierce international competition for attracting foreign direct investment, and a rather limited domestic capital market, will not be achieved, unless major policy reforms and structural changes are undertaken to make the investment environment attractive for foreign and domestic investors.

Accordingly, the Government of Pakistan has devised an attractive policy package for attracting overseas investment and to facilitate the tapping of the domestic capital market to raise local financing for power projects. The main characteristics of this package are internationally competitive terms, attractive framework for domestic investors, reduction in local currency investment requirements, simplification of procedures, and steps to create and encourage a domestic corporate debt securities market.

The salient features of the new policy framework and the package of incentives that have been devised to accelerate the development of generation capacity through private sector resource mobilization are presented below.

B. **CHOICE OF SITE, FUEL/ENERGY SOURCE & TECHNOLOGY**:

The investors are free to propose the site and opt for the technology and fuel including residual furnace oil, diesel oil, natural gas, LPG etc. for the project depending upon the availability of fuel, cooling water, infrastructure, environmental impacts and economics of the tariff.

Investors may also propose projects based on hydro, or other renewable and/or nonconventional sources of energy such as solar, wind, geothermal etc.

However, hydro power projects on the main river Indus will not be open to private sector because of water regulations and flood protection functions.

C. **TARIFF FOR BULK PURCHASE OF POWER AT BUS BAR**:

The power shall be purchased by WAPDA/KESC under a long term contract covering the concession period.

The Government of Pakistan offers a Bulk Power Tariff of US Cents 6.5/kWh (to be paid in Pak Rupees) as an average for first ten years for sale of electricity to WAPDA/KESC.

A levelized tariff of US Cents 5.9/kWh (Rs 1.776/kWh) over life of the project has also been calculated as a final parameter for acceptance of the tariff. It will provide flexibility to the Sponsors to work out year-wise tariff (resulting into the required levelized tariff) which match their annual debt service requirements.

A premium of US Cents 0.25/kWh based on the energy sold to WAPDA/KESC during the first 10 years of project operations, will also be allowed to the projects above 100 MW which are commissioned under this scheme by end 1997.

1. <u>Application of Bulk Power Tariff</u>:

The Bulk Power Tariff will apply to all BOO thermal power projects, all hydro projects upto 20 MW and all other projects based on non-conventional/renewable energy sources. In case of hydel units, the levelized tariff will be applicable for the first 30 years of the project life.

For hydro projects exceeding 20 MW, the tariff will be decided on project to project basis on a 25% rate of return on equity.

2. <u>Payment of Bulk Power Tariff</u>:

The tariff of US Cents 6.5/kWh is an indicative tariff which has been calculated on an annual plant factor of 60%. The actual payment of the tariff will comprise two components, i.e. Capacity Price and Energy Price.

Capacity price will be paid on monthly basis and covers the debt servicing, fixed operation and maintenance cost, insurance expenses and return on equity. The payment of Capacity Price on monthly basis will keep the investors' profit insulated against variations in the quantum of energy purchased by WAPDA/KESC.

The Energy Price will be paid as Rupees per kWh based on actual energy sold to WAPDA/KESC. This includes an element of fuel price as a "pass-through" item. As the capacity payment is assured as per terms of the Concession Agreements, there will be no guarantee for purchase of a specified amount of power. However, as mentioned earlier, non-purchase of electricity will not affect the smooth operations and investors' profits as envisaged in the base tariff profile.

3. <u>Procedure for Application of Bulk Power Tariff</u>:

The Sponsors of private power projects will provide their year-wise tariff profile for the life of the project. The tariff will be acceptable if:

i) The average tariff for the first ten years does not exceed US Cents 6.5/kWh (Rs 1.952/kWh).

ii) The annual base tariff does not exceed US Cents 8.33/kWh (Rs.2.5/kWh) in the first year and US Cents 6.66/kWh (Rs 2/kWh) in any subsequent year.

iii) The levelized tariff for the life of the project does not exceed US Cents 5.91/kWh (Rs.1.776/kWh).

4. Indexation/Adjustment of the Bulk Power Tariff:

A mechanism has been provided for indexation/adjustment of the certain tariff components based on Rupee/Dollar exchange rate, fuel price variations and inflation, as described in Annexure-I.

D. **FINANCING ARRANGEMENTS**:

1. BOO projects will involve limited recourse financing, which means that the funds for the projects will be raised without any direct sovereign guarantee of repayment. Instead, the investors in, and lenders to, the project company must look to the revenues earned by the sale of electricity; for their returns on equity and the servicing of their loans.

2. The minimum requirement for equity investment is 20% of the total capital cost of the project.

3. The Government has established a Private Sector Energy Development Fund (PSEDF) with the assistance of the World Bank, USAID and other multi-lateral lending agencies, which may provide upto 40% of the Capital Costs of the project, currently at a fixed interest rate of 14% per annum with a maturity period of upto 23 years including a grace period of upto 8 years.

4. To facilitate the creation and encouragement of a corporate debt securities market essential to raise local financing for power development projects, the following

provisions have been made:-

i) Permission to power generation companies to issue Corporate Bonds, both bearer and registered.

ii) Permission to issue shares at discounted prices to enable venture capitalists to be provided higher rates of return proportionate to the risk.

iii) Permission to foreign banks to underwrite the issue of shares and bonds by the private power companies.

iv) Same tax facilities for private sector instruments as available to Non Banking Financing Institutions subject to approval by CLA.

v) Recommendation by GOP to State Bank for modification of Prudential Regulations to allow 80:20 debt equity ratio.

vi) Removal/reform of Section 13 of 1947 Foreign Exchange Regulation Act to enable non-residents to purchase securities issued by Pakistanis without State Bank permissions.

vii) Abolition of 5% limit on investment of equity in associated undertakings.

viii) An independent rating agency is being allowed to commence operations, so that individual investors can make informed decisions about the risk and profitability of the Bonds/TFCs.

E. **<u>FISCAL INCENTIVES</u>**:

1. The private power companies are exempt from corporate income tax.

2. The companies are allowed to import plant and equipment without payment of customs duties, sales tax, Iqra, Flood Relief and other Surcharges as well as Import License Fee.

3. The companies have been allowed to register anywhere in Pakistan to avail reduction in stamp tax and registration fee for registration of loan documents by Federal Government.

4. Repatriation of equity alongwith dividends is allowed freely.

5. Exemption from income tax in Pakistan for foreign lenders to such companies.

6. Although the GOP encourages participation of local investors in the power sector, it is not mandatory, and foreign companies/investors are free to set up projects without local partners.

7. The companies can obtain Foreign Exchange Risk Insurance (FERI) on standard terms from the State Bank on the foreign currency loans contracted by them. The current premium rates of FERI are included in the bulk tariff but any change in FERI will be considered as a "pass-through" item.

8. The companies have been exempted from the requirements of obtaining insurance only from the National Insurance Corporation (NIC) under NIC Act of 1976 if they are funded by multi-lateral lending agencies like World Bank, ADB etc. Now private power companies can get insurance as per requirements of lenders and utilities.

9. The power generation has been declared as an industry and the companies are eligible for all other concessions which are available to industrial projects.

10. The private parties may raise local and foreign finance in accordance with regulations applicable to industry in general.

11. For local engineering and manufacturing companies, the present Statutory Revisionary Order (SRO) 555(1)/90 has been made applicable to private power plants.

12. Orders received by local engineering and manufacturing companies from private power companies will be treated as an export for refinance under the State Bank Finance Scheme for Exports.

F. <u>SECURITY PACKAGE</u>:

1. Model Implementation (Concessions) Agreement, Power Purchase Agreement and Fuel Supply Agreements have been prepared for private power projects to eliminate the need for protracted negotiations between GOP and Sponsors.

2. The long term Power Purchase Agreements, typically for 15 - 30 years with WAPDA/KESC are guaranteed by the GOP for performance obligations of these utilities.

3. In case the fuel is to be supplied by a public sector organization, the performance of the fuel supplier will be guaranteed by the GOP under the terms of Fuel Supply Agreement.

4. For private power projects, the Government will:

   i) provide protection against specific force majeure risk.

   ii) provide protection against changes in certain taxes and duties

   iii) ensure the convertability of Rupees and remittability of foreign exchange to cover necessary expenses of the projects.

5. The PSEDF loans are subordinated in certain respects to the other commercial lenders.

G. **<u>ONE WINDOW OPERATION</u>**:

Previously the GOP institutional framework to facilitate the development of private sector power projects comprised:

1. A Private Power Cell (PPC) in the Ministry of Water and Power (MWP) at Islamabad that promoted and evaluated proposals for, and concluded agreements relating to, private sector power projects.

2. A Private Energy Division (PED) in the National Development Finance Corporation (NDFC) in Karachi that administered the Private Sector Energy Development Fund on behalf of the Government and provided loans to approved projects

3. A WAPDA Power Privatization Organization (WPPO) in WAPDA at Lahore that was responsible for negotiating and administering Power Purchase Agreements.

Under the new policy, a Private Power Board is being constituted so as to facilitate one window operation. The Board will be responsible for coordinating with all the agencies and Ministries concerned and taking decisions, monitoring the performance of private sector projects in accordance with the agreements, and safeguarding the interests of the consumers.

H. **ISSUANCE OF SEPARATE SRO**:

A number of exemptions and fiscal incentives are already in existence, while certain new incentives have been proposed under the new policy. A separate Statutory Revisionary Order (SRO) is being issued for private sector power plants so that incentives and concessions given in various regulations and directives are placed together and consolidated to facilitate understanding and implementation of the incentives package.

I. **SUPPLY AND IMPORT OF FUEL**:

Private investors will be responsible for arrangements of fuel for their power plants. They are free to opt either making their own importation and transportation of fuel (oil, LPG and LNG) for their power plants (including development of import handling and transportation infrastructure, if needed), or enter into a Fuel Supply Agreement (FSA) with producing or marketing companies, either in the public or private sector. In any case, the fuel price will remain a "pass-through" based on the price changes made by the public sector (GOP) in the same fuel.

However, in case the FSA is made with a public sector organization, the GOP will guarantee the performance of fuel supplier.

J. **PROCEDURES FOR APPLICATION AND PROCESSING OF PROPOSALS**:

1. Unsolicited Proposals:

i) On receipt of a fee of Rs 5,000/= the Private Power Board (PPB), currently Private Power Cell, will register the applicants and provide them with a set of documents comprising Brochure outlining new policy, Model IA, PPA and FSA, application form and format of bank guarantee.

ii) Applications will be accepted by PPB against payment of a non-refundable application fee to be received as follows:

0-50 MW	Rs 100,000
51-100 MW	Rs 200,000

101-200	MW	Rs 300,000
201-300	MW	Rs 400,000
Above 300	MW	Rs 500,000

iii) In case PPB considers that the proposal has been found to be technically and financially viable, a Letter of Interest will be issued to the Sponsors of the project. Within six weeks of the receipt of the Letter of Interest from PPB, the applicant shall have to furnish a Performance Guarantee, valid for one year and encashable without recourse to the applicant, in the form of an irrevocable bank guarantee from a scheduled local bank or from a reputed foreign bank acceptable to PPB. Insurance or Corporate Bonds shall not be acceptable as Performance Guarantee. The amount of Performance Guarantee shall be Rs 100,000 per MW based on the capacity for which LOS will be issued. If the Guarantee is not furnished within six weeks, the Letter of Interest will automatically lapse, and neither the Sponsor nor the project company shall have any claim for compensation or damages against the Government of Pakistan or any other Governmental agency on any grounds.

iv) On receipt and acceptance of Performance Guarantee by the PPB, a Letter of Support will immediately be issued to the Sponsors. The IA and PPA will be initialled/signed within a period of six weeks of the issuance of the LOS.

The Guarantee will be encashed in case the Sponsors are unable to achieve financial close within one year of the issuance of the LOS. Under normal circumstances no extensions will be granted. However, if on the Sponsors' request for extension, PPB is satisfied that delays are due to the factors beyond the control of the Sponsors and financial close will be achieved very shortly, an extension of a maximum of three months will be given against extending the validity period of the Guarantee and raising the Guarantee amount by 100% i.e. Rs 200,000 per MW.

2. <u>Solicited Proposals</u>:

In case of a solicitation for a specific project by the PPB, the pre-qualifications of the bidders will be made through advertisement in the international press. After receipt of proposals the pre-qualified bidders will be ranked according to the bid criteria. A premium will be given to the minimum time indicated for achieving financial close, start of construction and commercial operations of the project. The first ranked party will be given 15 days to submit the Performance Guarantee covering the period of financial close indicated in the bid, failing which the second ranked bidder will be invited and so on. If the Performance Guarantee of the first party is forfeited, the second ranked party will be provided an opportunity to submit the Performance Guarantee and go ahead for the financial close, and so on.

3. Projects in the Pipeline:

The new policy will also apply to all other projects currently in the pipeline for which LOI/LOSs have been issued. The Sponsors of such projects will be issued Letters of Invitation alongwith a copy of the new policy document and draft IA, PPA and FSA by the PPC/PPB. They will be invited to convey their acceptance, and deposit the Application Fee and Performance Guarantee in the amounts prescribed under paragraphs J.1(ii) and J.1(iii) above within three weeks of the date of the Letter. If the Sponsors decline to proceed further under the new policy, the GOP will be entitled to allocate the site to any other investor. The project's Sponsors will be expected to finalize/initial the IA, PPA and FSA within six weeks of their acceptance of the Invitation, and to achieve financial close within 8 months from initialling/signing of IA, PPA and FSA. In case the financial close is not achieved within 8 months, the guarantee will be liable for encashment/extension as stated under paragraph J.1(iv) above.

4. Preferred Locations:

A list of preferred locations for thermal power projects alongwith desired capacity will be made available with the initial set of documents on request. GOP will prefer that the projects are located on these sites. However, any other location will also be considered subject to its feasibility from load, transmission and environment points of view.

K. **INTERCONNECTION OF THE PROJECT TO WAPDA/KESC TRANSMISSION SYSTEM**:

The power will be purchased from the private power sellers at the outgoing terminal (interconnection point) of the HV/EHV substation of the power plant and the transmission line for interconnection with the national grid will be provided by WAPDA/KESC. The cost of interconnecting facilities upto outgoing terminals of the private power projects (including step-up autotransformers, HV/EHV breakers and associated switchgear) will be borne by the private power sellers.

L. **VALIDITY PERIOD OF THE BULK POWER TARIFF:**

The Bulk Power Tariff will be applicable for the projects executing agreements between January 1, 1994 to December 31, 1994. The premium of 0.25 Cents/kWh will be applicable to the projects commissioned before the end of 1997. The tariff will be revised on annual basis and the new Bulk Power Tariff will be announced for application from January 1 to December 31 every year.

M. **INDUSTRIAL SELF-GENERATION PROJECTS**:

The incentives offered by the Government for setting up companies for self-generation by industries have drawn an encouraging response. In order to give further impetus to, and accelerate setting up of self-generation plants in industry, legislation along the lines of PURPA i.e. Public Utility Regulatory Policy Act of 1978, USA is being enacted to encourage small to medium scale power production in the industrial sector. The legislation will provide such industries with the following options:

1. Sale of surplus power to the power utility, subject to the guarantee that the utility will buy any and all such power offered for sale, and that the full avoided costs will be paid for such purchases. (These currently (1993-94) vary between 73 & 206 Ps/kWh depending upon time of the day & season. Details are available in Annexure-II.). Alternatively, the producer may opt for an as-available, as-needed type of arrangement for sale at 80% of the bulk tariff rate.

2. In case of industry situated in rural areas, away from the national grid, the industry will be encouraged to set up and operate a rural distribution network in its vicinity, for which subsidies similar to those implicit in WAPDA's rural tariffs will be provided by the Government. A package of incentives for setting industry in rural areas to promote integrated rural development will be a part of the proposed legislation.

In addition to the proposed legislation, the Government will pro-actively support and promote development of energy-efficient generation capacity in the industrial sector through preparation of feasibility reports in respect of energy-efficient generation technologies such as combined cycle gas turbine, gas-diesel plants and thermal plants using agricultural wastes as fuel.

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