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Pathfinder Economic Alert

Powering the Energy Sector: Energizing the Power Sector

Sri Lankan farmers, small and medium enterprises, service providers, big businesses and households have been afflicted by one of the highest electricity tariffs in the world and uncompetitive fuel costs for many years. This has been undermining the economy's competitiveness thereby discouraging investment and employment generation. The enormous losses incurred by the CEB and CPC have added to the debt burden imposed on the current and future generations of Sri Lankans.

Taking this reality into consideration the authorities have recently initiated policy- oriented studies to identify causes and make recommendations for policy and regulatory reforms. Similarly, action has been taken to expedite the implementation of key power generation projects. While Sri Lanka is blessed with engineers and technicians of high standard the current outcome is due to the existing structure of the power and energy sector inherited from time in memorial.

The Pathfinder Foundation (PF) has stressed time and again that globalization places a high premium on competitiveness. As power and energy are arguably the lifeblood of a modern economy, the electricity tariff and fuel price are key determinants of the competitiveness of enterprises operating in all sectors of the economy: manufacturing, services and agriculture. They affect entities ranging from large corporations to small and micro-producers. In such a context, it is important to ask the question why these prices have been so high in Sri Lanka. High generation and distribution costs are both explanatory factors as is the uncompetitive structure of the sector which breeds inefficiency.

High Electricity Generation Costs: the Legacy of Indecisiveness.

The high electricity generation costs may be attributed, to a significant extent, to the inordinate delay in supplementing hydro with coal-based power generation to meet increasing demand. (High prices built into the contracts signed with independent power producers have also been a factor). It took three decades for the first phase of the initial coal-based power generation facility to be completed in Norochcholai. The delay may be attributed to various vested interests that blocked progress for different reasons, some well-intentioned. This led to an unnecessarily excessive reliance on expensive heavy-oil based power generation. This was entirely avoidable with better planning and more decisive political action in the face of vested interests. The upshot was a burdening of households, businesses and farmers with increased costs directly in the form of higher electricity tariffs and indirectly through foregone investment, employment and incomes stemming from a reduction in competitiveness flowing from a higher electricity cost structure in the economy.

Commendable Actions in Recent Past.

The authorities are to be commended for bringing Norochcholai on stream. Similarly action is being initiated for speedy implementation of the Sampur project with Indian collaboration. This increases the scope for reducing the electricity tariff, particularly if distribution costs are also contained through improved management of the electricity supply chain. Renegotiation of the IPP contracts, which are expiring, can also assist in this regard. It is reported that such initiatives are being taken by the relevant agencies which would lead to a lower cost of power generation.

Gasification of the Energy Sector.

In addition, the discovery of natural gas in the Mannar basin is a potential game-changer in terms of the country's energy security (see PF's Energy Alert at www.pathfinderfoundation.org). In this regard, speedy and decisive action is needed on key issues, such as pricing and export policies to expedite the commercialization of the discoveries which would serve to reduce the cost of energy in the economy.

Monopolistic Structures: a Recipe for Inefficiency.

The current high energy costs are also partly due to the monopolistic structure of the sector. It is dominated by large state-owned enterprises (SOEs) and is inherently uncompetitive and very prone to inefficiency, particularly in a context which has, for decades, been politicized and driven by patronage. Past experience has demonstrated that even when some efficiency enhancing reforms have been implemented, from time-to-time, they have been inevitably eroded/reversed. This is always likely given the lack of competitiveness in the sector. Furthermore, the current state -dominated structure also means that important investment is not undertaken in a timely manner due to fiscal constraints stemming from an over-stretched Government Budget. The inefficiencies that arise in an uncompetitive and politicized system also bloat costs and make it difficult for the relevant SOEs to adopt a pricing policy which enables them to generate sufficient resources to meet their capital outlays. This has led to problems including breakdown of very basic infrastructure, such as pipelines from shipping buoys to storage tanks, running down of the internal transport fleet of the CPC ; and leakages from the distribution lines.

The government's monopoly over the import and refining of oil is a massive source of inefficiency and malpractice. It is not possible to justify the status quo. High priority should, therefore, be attached to move to a more competitive structure supported by effective regulation. One may conclude that the state-owned monopolistic structure has been yielding high energy costs which erode disposable household incomes; undermine competitiveness of business activity at all levels and in all sectors, resulting in foregone investment, employment and incomes; and impose a debt burden on the country.

Circular Flow of Debt Burden: SOEs → State Banks → Treasury.

The massive losses that have been incurred by the SOEs are eventually shifted on to the government's balance sheet resulting in an increase in the stock of public debt. These losses are initially borne by the balance sheets of the Bank of Ceylon and People's Bank. This has been an important contributory factor in the periodic re-capitalization of the two state banks through issuing of Treasury Bonds. In fact, there have been reports that the Bank of Ceylon is seeking a re-capitalization to the tune of Rs. 10 billion to strengthen its capital adequacy ratios. This will, of course, add to the outstanding Government debt.

Towards a more Competitive Structure

The future should entail the following:

- A forward-looking electricity generation strategy based on the most cost- efficient and reliable combination of sourcing from hydro, coal, natural gas and renewables.
- A more efficient distribution system, including through improved management of the electricity supply chain.
- The formulation of a medium-term strategy for the petroleum sector.
- The entry of additional players alongside CPC and LIOC to have an industrial structure that promotes greater efficiency and improved service delivery through increased competition.
- Ending the monopoly enjoyed by the CPC over the import and refining of oil with its old, obsolete and highly inefficient refinery at Sapugaskanda. Refining should be opened up to new players capable of investing in state of the art technology, equipment and processes. Implementation of the Maritime & Aviation Hub concepts requires fuel supplies at competitive prices vis-a-vis Singapore and Dubai air & seaports. The status quo simply does not create the enabling conditions for this. It should be recognized that private investment (domestic and foreign) would avoid imposing a burden on the constrained Government Budget and avoid an adverse impact on the country's debt dynamics which are a source of concern.
- Strengthening the capacity of the regulation drawing on world class expertise as and when necessary.

Frank Discussion on Structure of Petroleum Sector: A Must for "Honeymoon".

For too long, the people of Sri Lanka have been greatly short-changed by a highly inefficient power and energy sector. Inefficient state monopolies have been a bane rather than a blessing for Sri Lankan consumers. Their inefficient operations have imposed unnecessary hardships on the people and undermined the economic prospects of the country. High priority should, therefore, be attached to having an open and frank discussion about the need for a radical overhaul of the structure of the petroleum sector as soon as the anticipated elections are completed and the ‘honeymoon period’ opens up the opportunity to undertake bold reforms which would reduce the burden on households and increase the competitiveness of the whole economy.

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