'COMMENTARAO' in "The Telegraph" of December 10 2014

"Electrifying truths

- Banks may collapse because of power sector indiscipline" by S L RAO

—

Electrifying truths
- Banks may collapse because of power sector indiscipline

COMMENTRAO: S.L. Rao

P.V. Narasimha Rao, before he became prime minister, read all the reports by L.K. Jha and the economists employed at the World Bank, about what must be done to put Indian economy on the growth path. As prime minister, he came with a clear vision of goals and how to reach

them. The reforms that followed transformed the Indian economy.

A report reviewing the Indian power sector written by the Indian economists, Sheoli Pargal and Sudeshna Ghosh Banerjee, at the World Bank, has the potential to transform the Indian power sector. The energy sector in India has been dominated by welfare ideology, poor implementation, inefficient institutional mechanisms, rampant populism, bureaucratic capture and compromises. The ideology is that State ownership is honest and more concerned about consumer interests. There is an unwillingness to accept that producing a surplus is important for any investment in order to provide sustained good service and to build more capacity. A preference for charity given to disadvantaged groups rather than opportunity has dominated the sector. Tariffs are skewed to favour the poor and needy groups like those under agriculture, but with no mechanism to ensure that the needy are properly identified. The State-owned electricity boards and others owning coal and gas function as government administrations. Independent regulatory mechanisms, created to insulate the sectors from political interference, are captured (like the State enterprises) by the top level bureaucracy. They function largely in compliance with government wishes. There is little financial discipline: the enterprises amass huge debts paid for by governments and are a burden on nationalized banks.

Government ownership (and guarantees) of banks has hidden the reality that this burden is excessive. It will lead to collapse or require their huge recapitalization by government. That will affect adversely the government's ability to build physical and human infrastructure and raise its deficit.

The Reserve Bank of India as bank regulator must come down hard on such uncommercial and normally doubtful debts. Banks must become more active in examining and demanding viability from their borrowers. They do not do so today. They are satisfied that the enterprises are owned by state governments, which, they feel, will pay their debts. Banks must focus on viability, not on the populism of low electricity tariffs.

The uncertain supply of fuels, mainly coal and gas, is an important reason for the financial straits of the electricity sector. Coal is a Central government monopoly, and hence a very profitable company. It shows little interest in the welfare of the electricity sector. Gas is dominated by a State-owned company and a large private producer which has considerable influence on government policies and actions. All gas transportation is by a government-owned monopoly.

The World Bank report analyses electricity distribution. "Aggregate technical and commercial (AT&C) losses, which measure utility operational and financial performance, have fallen from 38per cent to (a still-high) 26per cent over 2003-11. AT&C losses consist of distribution losses, which comprise losses due to both technical and nontechnical factors, and losses from collection inefficiency. Distribution losses have dropped from 32per cent in 2003 to around 21per cent on average in 2011 - so, despite the encouraging trend, utilities still have not been paid for more than a fifth of power they purchased and supplied. This is yet another burden on nationalized banks which have large outstanding [debts] from generating companies.

"D(d)istribution-utility revenue losses can be decomposed as follows: from under pricing (average billed tariffs below cost-recovery tariff levels), from under collection (full amount

billed), and from physical losses of energy (losses above international norms due to technical reasons or due to nontechnical factors, such as theft). In 2011, the absolute amount lost was highest in Tamil Nadu, followed by Rajasthan and Andhra Pradesh; losses in five states were more than 100per cent of distribution revenues earned.

"The time taken to collect payments... has contributed, through the collection rate, to the poor financial performance of distribution utilities. Average debtor days have come down from 213 days to around 170 over 2003-11 with the 10 best performers averaging 21 days in 2011 but the 10 worst 489 days, indicating gross mismanagement of cash flow.

"In 2003, in aggregate, states were charging an average billed tariff well above cost recovery, and losses that year were overwhelmingly driven by distribution losses - that is, above the norm physical losses of energy. By contrast, in 2011, in aggregate, states were charging an average billed tariff below cost recovery. Thus, underpricing emerged as an important contributor to losses, though distribution inefficiencies, while smaller than in 2003, continued to be the largest contributor to total losses.

"Calculated across all states, the margin of cost recovery declined over 2003-11 because tariff increases failed to keep pace with cost increases. Although the average billed tariff in 2011 was higher than cost recovery in 15 states, technical losses, theft, and undercollection can (and often do) lead to no revenue from a significant amount of power supplied by utilities. The fact that most utilities still make losses despite having tariffs at or above cost-recovery levels reinforces how much operational inefficiencies contribute to utility losses. Only Delhi, Kerala, and West Bengal had tariffs that covered costs in 2011 and made a profit without requiring a subsidy."

Any lender would review under recoveries, technical inefficiencies and the long duration debts of his customers. A bank's interest lies in its loans being productively used so that they are repaid on schedule. Nationalized banks do not do this with their power sector borrowers. The RBI takes a hands-off approach to such loans to State-owned enterprises.

The electricity sector's operating environment makes its operations more unviable. Unforeseen shortages of fuel (mainly coal) and poor planning by discoms have led to a steep rise in the price of bulk power bought by discoms. This principally widens the gap between discom costs and revenues. While the average revenue grew at a real compound annual growth rate of 6 per cent over 2003-11, the average cost of supply rose at about 7per cent, growing by 70per cent in real terms over the period. The share of power purchases in total costs rose from 56per cent in 2003 to 74per cent in 2011. Power has become more expensive because of a decline in domestic fuel availability, resulting in an acute increase in the price of fuel and because of poor procurement planning by discoms. Resultant last-minute purchases of power to supply end-consumers are from the spot market and are more expensive.

The electricity sector and, particularly, distribution are huge debtors to nationalized banks. Safeguarding India's financial system demands more attention from banks and the RBI.

The author is former director-general, National Council of Applied Economic Research