Expensive power and price adjustment

M SHAHIDUL ISLAM and SYEDA SALINA AZIZ

ELECTRICITY coverage in Bangladesh is among the lowest in South Asia. However, this statistics hides an important fact that there is a correlation between access to utilities and the level of income. In the case of key South Asian economies, this relationship is quite strong. Sri Lanka has the highest level of electricity coverage followed by India, Pakistan and Bangladesh.

Nevertheless, there are some political economy factors that affect the provisions of energy and other utility services. Prices for some utility services -- particularly electricity, gas and water -- are generally set below the costs of provision in developing countries, benefitting the urban middle class and high-income group who consume the lion's share of energy subsidies. With the extreme poor households' share in the total electricity consumption being at less than 0.1 percent, energy subsidy is highly regressive in Bangladesh. This also signifies the importance of rational pricing of energy.

While successive governments had reformed various aspects of energy and utility services, notably generation and distribution in the power sector, they had been reluctant to reform energy prices until recently, fearing a possible backlash from the voters and consumer rights groups.

However, faced with severe fiscal and macroeconomic constraints as well as pressure from donors and development partners, the current government started to adjust oil and electricity prices since assuming power in 2009, with electricity tariffs being adjusted upward numerous times.

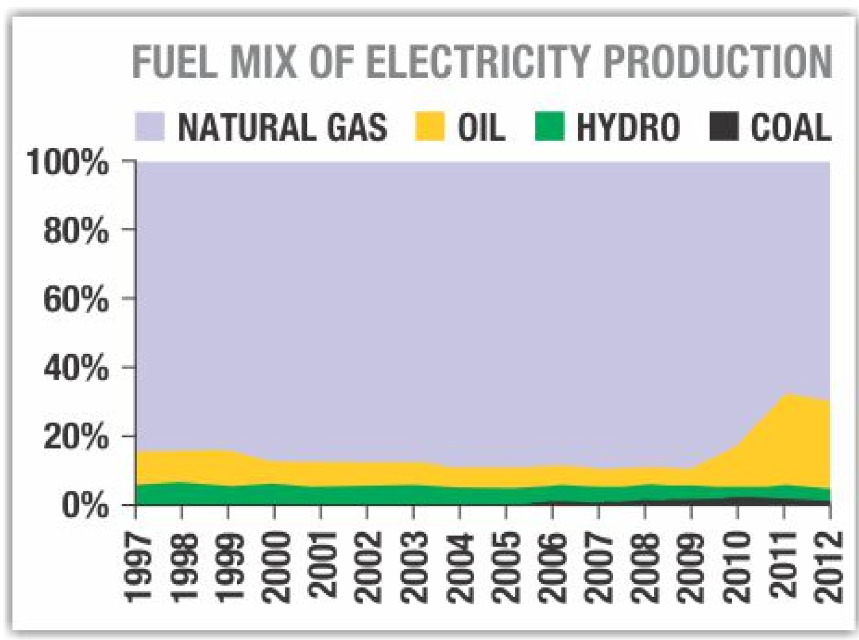
Moreover, the supply cost of electricity has increased sharply in recent years owing primarily to changes in fuel mix in electricity production. This has a direct link to the current government's ambitious plan to augment the supply of electricity to bridge the marked gap between the sector's supply and demand. While the government's energy roadmap targets electricity production from various fuel sources, in recent years the sector's dependence on fuel oil increased sharply from 5 percent in 2008-09 to more than 20 percent in 2011-12.

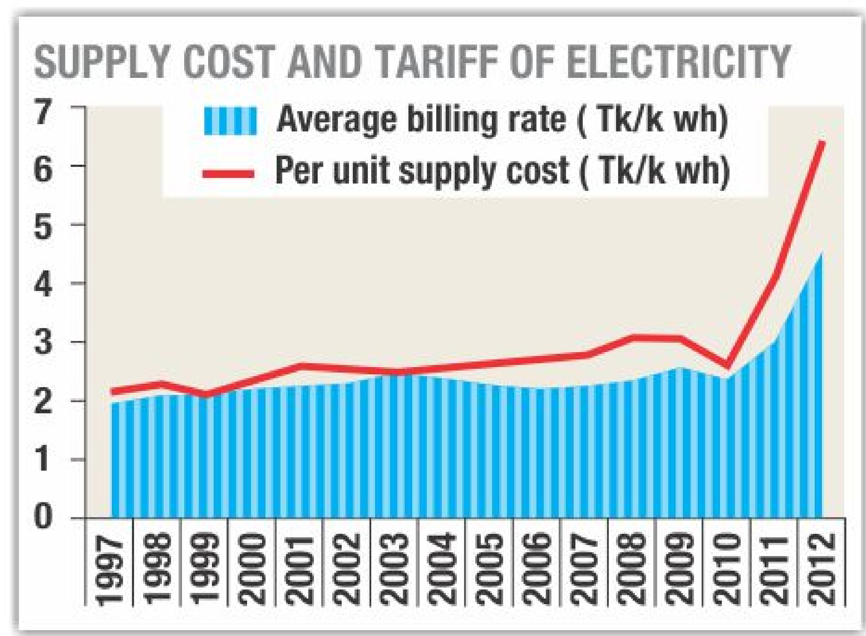
Electricity tariff in Bangladesh would have been much higher than the current level, had gas prices not been heavily subsidised. The other sources -- hydroelectric and coal power -- comprise approximately 5 percent of total power production.

Given the fiscally unsustainable fuel mix as well as sharp rise in electricity tariff, loom as to whether the government will be able to diversify its fuel sources of electricity by attracting large investment in gas production and developing indigenous coal resources or importing coal resources from abroad.

The power sector has already experienced the limit to rental power plants. Given the higher fuel costs in the international markets, rental power plants run at 57 percent capacity on an average. Moreover, more than 600 MW power cannot be generated due to a gas supply shortage.

Thus, despite higher generation capacity in recent years, the government has been unsuccessful in providing cost-effective electricity. Hence, it is important to understand the sector comprehensively. Reform in the sector is one of the ways to assess what policies have and have not worked in the past, towards understanding the sustainability of current policies on energy pricing.





SOURCE: BASED ON BANGLADESH POWER DEVELOPMENT BOARD

It was only in the mid-1990s that the power sector witnessed a major policy shift, when the government in consultation with a large number of donors and development partners launched a reform project. Reform in the sector has increased private participation particularly in power generation. The sector's commercial performance improved significantly in reducing power distribution losses and in the operational performance of transmission system. The regulatory body -- Bangladesh Energy Regulatory Commission -- has also been formed whereby private and public sectors now have equal share in power generation.

The ruling party has shown interest in reforming electricity generation and transmission which gives them opportunities to align their political and economic interests. During the past BNP government's tenure, considerable focus was placed on increasing transmission capacity though it was widely reported as serving their interests. However, their priority to increase electricity transmission above generation capacity proved to be a wrong move in light of the chronic load-shedding.

Increasing electricity generation capacity has been a major focus for the current government. When the AL government assumed power in January 2009, the effective capacity of power generation stood at around 3,500MW. The government has added more than 4,000MW in various forms, including liquid fuel-based, gas-based and dual fuel plants. Bangladesh Power Development Board's power generation report shows that in 2012, the total generation capacity stood at more than 7,700MW, while the actual production has been between 4,000MW and 5,000MW.

Consequently, the key objective of the power sector reforms agenda remains unfulfilled. While some of the power generation constraints are addressed, the government has offered an expensive solution to power woes. To find an answer to the unfulfilled objectives of such reforms, it is essential to examine the political economy of power mix.

According to the Power System Master Plan, the forecasted demand for electricity is 19,000MW in 2021 and 34,000MW in 2030. To meet the growing demand, the plan suggested a fuel mix comprising 30 percent domestic coal, 20 percent imported coal, 25 percent natural gas including liquefied natural gas, 5 percent liquid fuel and 20 percent nuclear, renewable energy and power import.

It is not unusual that preference is heavily skewed towards coal at 50 percent since this form of hydrocarbon produces approximately 40 percent of electricity globally, followed by natural gas (22 percent), renewable (19 percent), nuclear (14 percent) and liquid fuels and other petroleum (5 percent). Coal is the main source of primary energy both in China and India. Even one-third of the United States' electricity is generated by coal.

The stock of primary energy indicates that Bangladesh has comparative advantage in producing electricity from coal and gas. However, Bangladesh's transition to a diversified fuel mix, particularly coal-based electricity production, faces considerable hurdles. Due to environmental concerns, the donors and development partners, left-wing political parties and civil society organisations are opposed to producing electricity from coal with the existing technology.

Moreover, the elected governments do not have much incentives or capacity under the competitive clientelist political settlement to develop long-term projects such as base-load power plants. A leading political economist observed, "The problem in the power sector is that long-term contracts and calculations are difficult when the political settlement has features of competitive clientelism with short time horizons of the ruling coalition and with low and declining governance capabilities of the bureaucratic organisations, who regulate the investment in these sectors."

Market-based reforms in energy and utility sectors have been unsuccessful in improving the overall governance quality, thereby precluding the long-term investment in the sector critical for cost-effective electricity production. The sector has been highly successful in reducing system loss. However, a plethora of governance issues such as longer maturity time of projects, lengthy procurement processes, weak contract enforcement, higher technical system loss, collusion and corruption, poor internal governance, higher levels of investment risks and bureaucrats' risk-averse approach bar the flow of large-scale external finance and technology.

As a result, the power sector has had little success in developing coal and gas-fired base load power plants over the past three and a half years. The government, its agencies and private sector players have given more focus on rental power plants that rely on oil as a primary fuel and can be materialised within six months to a year.

Although the oil-based rental power plants should have been phased out by this time to allow other primary fuels, these plants are likely to maintain their share in the next few years, increasing supply cost of electricity and undermining the power sector reform.

The writers are research fellow and senior research associate, respectively, at the Institute of Governance Studies, BRAC University. They can be contacted at imonsg@gmail.com

Consumption bets will outperform in India

ANDY MUKHERJEE

THE Indian economy has at least another year of poor-quality GDP growth ahead of it, even if the pace of expansion is somewhat faster than the 5.5 percent expected for 2012.

The quality of growth will disappoint because a much-needed pickup in investment is not yet on the horizon. The credit cycle is still weak; state-owned banks are hobbled by bad loans. For investors, it means cash-rich consumer goods makers may be superior bets in 2013 than credit-dependent infrastructure and capital goods companies.

Consumption will remain well-supported by strong rural wage growth and government subsidies on food, fuel and fertilizers. Despite all the talk about the urgency of fiscal consolidation in India, public spending will remain high, as it tends to do in pre-poll years. And that will put more cash in people's wallets.

Domestic consumption will also get a boost from an improvement in exports. Global demand conditions will probably not deteriorate any further in 2013, and that will drive a steady recovery in India's manufacturing output, leading to job creation and wage growth. The surge in industrial production in October is a welcome signal.

Spending power will increase in real terms as inflation stops being as big a drag on consumer sentiment as it has been this year. The pace of rising prices won't fall as low as 5 percent, but it will decelerate from its current 10 percent - assuming oil prices don't spike.

Fears of a sudden demand collapse in the United States from large, abrupt cuts in government spending and tax increases are keeping oil prices in check; and that helps a large energy importer like India. Even then, if the US economy does jump off the "fiscal cliff," or if the sovereign-debt worries in Europe resume, heightened risk aversion among global investors will choke capital flows to India, and that will be bad news for an economy addicted to overseas funding.

Assuming a more benign outcome for the US and European economies, India's GDP growth should accelerate by about 1 percentage point in 2013. A revival in leveraged consumption will play an important part. The share of retail loans in GDP is yet to revert to its 2008 peak. High interest rates

AFP

Indian artisans paint traditional designs on earthenware pots at an annual handicraft fair in Siliguri yesterday.

have discouraged individual borrowers over the past couple of years. As domestic interest rates start easing off, there will be a recovery.

Banks will also be keen to write loans for autos and white goods purchases next year because households are in better financial shape than corporate borrowers, whose balance sheets are still clogged by the wreckage of a previous credit binge. Morgan Stanley is forecasting 18 percent growth in bank loans to retail customers next year. If that happens auto sales, which are currently stagnant, should again see double-digit growth by the end of 2013.

All of this suggests that betting on India's private consumption may be a more profitable trade for investors than hoping for a revival in capital expenditure.

An MSCI index of consumer discretionary stocks in India has risen fivefold in four years. These shares are now trading much higher than at the peak of the bubble market in early 2008. Meanwhile, shares of Larsen & Toubro, India's largest construction company and a proxy for investment demand in the economy, are languishing a fifth below their January 2008 level. Those of Jaiprakash Associates, a large infrastructure company, have slumped to a third of their peak value.

It's too early to bet on a reversal of fortunes. Order books of capital goods manufacturers are still in the doldrums as projects remain stuck for want of regulatory clearances: a property development project in Mumbai needs more than 50 separate government approvals. The creation of a cabinet committee on investment, announced last week, is a welcome first step. The committee will be headed by the prime minister and may over time become a force for good. But in the short run the panel will be handicapped by its inability to override individual ministries, where the delays occur.

The central bank will trim its policy rate in the first quarter of 2013, but that won't make a big difference to corporate credit demand and supply, especially in the infrastructure industry. In the absence of a well-functioning corporate bond market, banks have already built a huge exposure to infrastructure, the bulk of which is performing poorly. Lenders don't have the appetite to finance more roads.

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The colour of money shouldn't be blood red

YURY FEDOTOV

HSBC's $1.92 billion payment to US authorities to avoid prosecution for money-laundering practices, including transferring funds for Mexican drug cartels, raises serious questions about the flow of narco-cash in the international banking system. The time has come to tackle the culture of impunity that allows these illegal transactions.

The illicit drug trade remains international organised crime syndicates' most lucrative source of income. Drug traffickers may be laundering up to 70 percent of the estimated $320 billion they make from illicit drugs annually, according to United Nations Office of Drugs and Crime (UNODC). Yet officials have been able to seize less than 1 percent of this.

In Central America, for example, we have all seen the effects of crime and drug trafficking. When criminals fight, it is innocent bystanders who often die. The homicide rate in El Salvador is 69 killings per 100,000 citizens; in Guatemala it is 39 per 100,000; and in Honduras it is 92 per 100,000. By contrast, in Great Britain, the homicide rate is roughly 1.2 per 100,000.

Shutting down the cartels' cash flow could deal a significant blow to their operations and help rein in their lethal power. In 2010, UNODC put the value of the US cocaine market at around $33 billion, closely followed by the European market at $31 billion.

But our efforts will come to nothing if implementation is ineffective, compliance is inadequate and vigilance poor. When legal and institutional weaknesses are exploited, effective regulation is crucial. Without this, sophisticated criminals can always find ways to push dirty money into the legitimate financial system.

Some governments, such as Switzerland, have made great strides in addressing money -laundering and corruption through improved regulatory frameworks. But these regulations are only as strong as the compliance mechanisms at financial institutions, which are crucial in implementing them.

There has been progress. In some countries, including the United States, bank secrecy laws have effectively been scrapped and are no longer obstacles to money-laundering investigations. More financial companies are establishing ethics and compliance programs to build an accountable workforce that has the knowledge and tools to serve as a bulwark against illicit money.

But more needs to be done.

It would help to create a regulatory environment in which breaches are systematically punished. However, the tone must be set at the top. The commitment to deal with institutional failings and strengthen corporate social responsibility must begin with boards of directors and chief executive officers.

A shift in culture cannot happen soon enough. It requires leadership and determination. UNODC can help.

My office is engaged with top international banks in our common fight against money laundering and corruption. They need to adopt policies in line with the United Nations Convention against Corruption, and create checks and balances that reduce the opportunities for wrongdoing. The international legal instruments provide a common framework for cooperation. Let us use it.

Through the Stolen Asset Recovery Initiative of the World Bank and UNODC, we are helping governments confront criminals who launder the proceeds of crime through the international financial system. These are challenges that no country or region should face alone.

With the public's attention focused on the financial system, regulators and policymakers are eager to improve its robustness and integrity. In this climate, we need to make bankers aware of their obligations to support national and international efforts to combat organised crime, drug trafficking and corruption.

Transparent practices make good business sense. They build credibility and promote investor confidence. But far more is at stake than balance sheets. The laundered drug money is tainting the reputations of leading financial institutions.

Do banks really wish to help the drug kingpins who deal in death and destruction across continents? This moral argument should not be ignored.

Yury Fedotov is executive director of the United Nations Office on Drugs and Crime.