Bailing Out Unaccountability

Ashwini Chitnis, Shantanu Dixit, Ann Josey

The centre has approved a financial restructuring plan to deal with the losses of state electricity distribution companies, which are around Rs 1.9 lakh crore, or more than 2% of the country's gross domestic product. There is little doubt that the crisis is a result of the companies, state electricity regulatory commissions, state and central governments, and banks failing to ensure the existing legal provisions were implemented. While this bailout may be unavoidable, the plan does not address the issue of institutional accountability that is at the root of this crisis.

Ashwini Chitnis (*ashwini@prayaspune.org*), Shantanu Dixit (*shantanu@prayaspune.org*) and Ann Josey (*ann@prayaspune.org*) are with Prayas Energy Group, a Pune-based voluntary organisation working on policy analysis and advocacy in the energy sector.

The financial position of state electricity distribution companies (DISCOMs) has always been a cause of concern. This has once again come to the fore in the wake of a recent financial restructuring plan (FRP) for DISCOMs introduced by the central government. The total losses of DISCOMs, including short-term liabilities, are estimated to be around Rs 1,90,000 crore, which is more than 2% of the country's gross domestic product (GDP) at 2010-11 prices. Sadly, this is not the first time we are facing such a situation. According to the Ahluwalia Committee report of 2001 on "Settlement of State Electricity Boards (SEB) Dues", a number of schemes involving deductions from central plan assistance have been initiated by the central government for repayment of the accumulated dues of SEBs from time to time. Under a scheme in 2001, 50% of the interest payable by SEBs to various public sector undertakings in the power sector was waived and the remaining amounts were converted into long-term loans to be repaid by state governments over 15 years. The 15-year period is not even over and we face another bigger bailout. This article briefly traces the recent history of such bailouts, provides an overview of the proposed FRP, and based on an analysis of the factors responsible for losses, evaluates how effective it will be in preventing future bailouts.

The Ahluwalia Committee report of 2001, a year in which there was a bailout, laid great emphasis on operating SEBs on commercial terms and improving their efficiency by reducing aggregate technical and commercial (AT&C) losses. The Electricity Act of 2003 (hereafter EAct) laid down the framework for operationalising competition by way of open access, unbundling, and delicensing generation, and had provisions for improving the efficiency of the sector. It strengthened the hands of regulators by spelling out clear provisions for tariff determination, reduction of cross-subsidy (Sections 62 and 86), advance payment of subsidy by state governments (Section 65), and so on. This meant that the terms and conditions proposed in the 2001 bailout were converted into a binding law under the EAct. During the years 2005-08, as per provisions of the EAct, many states unbundled their electricity boards into separate generation, transmission and distribution companies. According to Section 132 of the EAct, a scheme for transfer of assets and liabilities had to be notified by the respective state governments. By way of this transfer scheme, the boards had to be converted into holding companies, which would retain all liabilities, while the newly formed DISCOMs would begin on an almost clean slate. In spite of such fundamental changes and reforms, the accumulated financial losses of DISCOMs increased from Rs 19,000 crore in 2004-05 to Rs 1,07,000 crore in 2009-10 (Shunglu Committee report).

In July 2010, the Planning Commission appointed a committee headed by former Comptroller and Auditor General

(CAG) V K Shunglu to review the financial problems of DISCOMs and identify corrective steps. The terms of reference of this committee included reviewing the accounts as on March 2010 and projecting what the losses would be by 2017, reviewing tariffs and examining the role of state governments, state electricity regulatory commissions (SERCs), and DISCOMs, and finally recommending a plan of action to achieve financial viability by 2017. The committee submitted its report in December 2011. It stated that accumulated losses for the preceding five years were Rs 1,79,000 crore before subsidy and Rs 82,000 crore after subsidy. The report attributed the losses to the poor managerial and operational performance of DISCOMs as well as irrational tariffs set by SERCs. Among its various recommendations, it suggested measures for improving the financial and functional autonomy of SERCs by streamlining appointments, and improving accountability through a review by an expert group.

It is not clear what the central government plans to do about implementing the Shunglu Committee's recommendations. Shortly after that, another committee headed by B K Chaturvedi, Member (Energy), Planning Commission, was appointed to suggest measures to improve the financial health of DISCOMs. Like the Shunglu Committee, it was supposed to submit its report before the Twelfth Five-Year Plan (2012-17) was finalised, so that its recommendation could be incorporated in the Plan. However, the Chaturvedi Committee's report is not public as yet. According to media reports, the present FRP has been introduced on the basis of the committee's recommendation.

Financial Restructuring

According to a notification dated 5 October 2012 issued by the Ministry of Power (MOP), the central government has approved a scheme for the financial restructuring of state DISCOMs. According to this, 50% of the outstanding short-term liabilities as on 31 March 2012 will be taken over by state governments. This will be done in the form of bonds to be issued by the DISCOMs to participating lenders, duly backed by state government guarantees. The maturity will not be more than 15 years, with a moratorium of three to five years on the repayment of principal. State governments have to provide full support to DISCOMs for repayment of interest and principal for this portion. The remaining liabilities (50%) will be converted into loans, which the DISCOMs will have to repay. The tenure of the loan will be rescheduled with a moratorium of three years on the repayment of principal. Repayment of both interest and principal for these loans will have to be fully secured by state government guarantees.

In addition, a transitional finance mechanism will be provided by the centre to support the restructuring effort. Under this, a grant will be given equal to the value of the additional energy saved by reducing AT&C losses beyond the trajectory specified under the Restructured Accelerated Power Development and Reforms Programme (R-APDRP). But the gap between average revenue realisation and average cost of supply has to be reduced by 25% this year, in comparison to 2010-11. The centre will also provide capital reimbursement support of 25% of the principal repayment by state governments if they take over the entire 50% of the short-term liabilities. Detailed guidelines for this mechanism are yet to be notified. A separate scheme will be worked out for financing operational losses and interest for the first three years, under which support will be given on a diminishing scale. The remaining portion of the operational losses will have to be financed by the respective state governments. The restructuring of loans is to be accompanied by the DISCOMs taking some concrete action on a set of mandatory and recommendatory conditions suggested in the scheme.

The mandatory conditions include in-principle approval from SERCs for the financial restructuring plan (FRP), notifying the tariff order for the fiscal year (FY) 13 before approval and ensuring that for the subsequent years, tariff order conforms to the model tariff regulations issued by the forum of regulators. The Appellate Tribunal for Electricity (APTEL) judgment on timely tariff revision is to be complied with and a time-bound plan for liquidation of regulatory assets along with carrying costs should be formulated. State governments will have to make a firm commitment to underwrite the shortfall as equity or interest-free loan if FRP targets are not met. The FRP target will also include progressive reduction in short-term power purchase. The release of agriculture subsidy should be made in advance as per Section 65 of the EAct. Prepaid meters should be installed for all government consumers and large consumers where defaults have occurred. There should be a time-bound plan for metering of all consumers. The DISCOMs should submit six-month status reports to the Central Electricity Authority (CEA), which will monitor progress on this front. Audited accounts for all years up to FY 11 must be finalised as a top priority and accounts for FY 13 should be finalised before 31 January 2013. Lenders can appoint a nominee director on the boards of DISCOMs. The recommendatory conditions include power procurement through competitive bidding, an action plan for identifying and writing off fictitious receivables, limiting the working capital facility to purchases and discounting of bills as per Shunglu Committee recommendations, operationalising open access as per the EAct, and SERCs notifying road maps for reducing cross-subsidy within six months of approving the FRP.

The scheme includes a monitoring mechanism by three different agencies. The first is state-level monitoring committees (SLMCs) headed by state chief secretaries or finance secretaries, with power secretaries as member secretaries, along with representatives of DISCOMs, lenders, the Reserve Bank of India (RBI) and CEA. The SLMCs will review the performance of DISCOMs on a quarterly

Appointments/Programmes/ Announcemnents

For the convenience of readers and advertisers, all advertisements on appointments, programmes, call for papers etc are now placed together at the end of each issue every week.

This section is also listed in the Contents page

Advertisements for books are published as before in the Book Review section.

basis till there is a turnaround and submit reports to a Centre-Level Monitoring Committee (CLMC). The CLMC will have the Member (energy), Planning Commission, as its chairperson and the secretaries of power, finance, and economic affairs as members, along with representatives of lenders, the RBI, the chairmen and managing directors of the Power Finance Corporation (PFC) and the Rural Electrification Corporation (REC) and CEA as member secretaries. The CLMC will meet every six months. The CEA will submit all proposals received from the states to receive benefits under the transit finance mechanism through the CLMC. Apart from the SLMCs and the CLMC, there will be third-party verification of the performance of DISCOMs by consultants appointed by the CEA, which will decide the terms of reference for this evaluation. Curiously, there is no representative from the state regulatory commissions on either the SLMC or the CLMC.

Tariff Revision

From the recommendations, it seems that the focus is on ensuring regular revision of the tariff. Most of the mandatory conditions such as preparing audited accounts (Companies Act 1956), timely tariff revision (Sections 62 and 86 of the EAct), and advance payment of subsidy (Section 65 of the EAct) are existing legal provisions. The rest of the mandatory provisions such as a time-bound plan for loss reduction, power purchase planning, operationalising open access, and reducing cross subsidy are already covered under regulations notified by the SERCs. Under the EAct, the SERC is the custodian of these functions. For example, for tariff revision, the SERC is required to review the progress on loss reduction, the metering status, undertake energy audits, and rationalise the tariff structure. The last has to be done considering cross-subsidy reduction and encouraging open access.

However, considering the spread and magnitude of the present problem and that there are legally binding provisions in the EAct that should have prevented it in the first place, there needs to be a thorough review of the effectiveness of the EAct provisions and their implementation. Even conceding that there may not be time for such a comprehensive process right now, the FRP should have at least aimed at determining why the EAct provisions have failed. Unfortunately, it neither acknowledges any shortcomings nor provides any measures to address them. The analysis below highlights how the FRP fails to deal with these institutional issues, though it is the only way to ensure that such crises do not happen again.

An examination of the accumulated losses and short-term liabilities shows that a high level of AT&C losses, a high proportion of short-term, high-cost power purchases, and delays in payment of subsidies by state governments are the three major reasons for the financial woes of DISCOMs. Table 1 shows AT&C losses in various states in 2006-07 and 2001-12, the period during which many of EAct reform measures were implemented. Barring Tamil Nadu, Andhra Pradesh and Punjab, most other debt-affected states have significantly high levels of loss, which act as a big drain on finances. Earlier experience with tariff revision shows that an increase in tariff does not ensure an equivalent increase in revenue. Even at lower tariffs, the DISCOMs are often unable to recover the approved revenue and incur losses. This implies that an increase in tariff alone will not lead to an improvement of a DISCOM's financial health.

Table 1: Aggregate Technical and Commercial Losses of Various States (%)

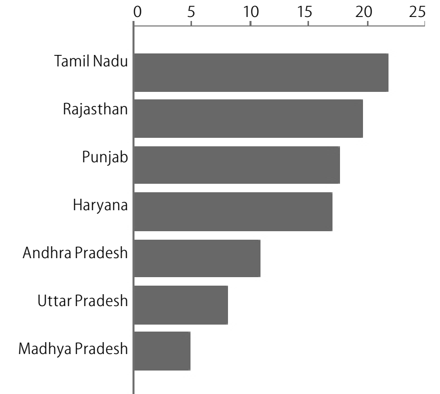
States	AT&C Losses	
	2006-07	2011-12
Andhra Pradesh	18	15
Punjab	23	17
Tamil Nadu	16	18
Haryana	26	23
Rajasthan	36	27
Uttar Pradesh	44	27
Madhya Pradesh	46	39
Orissa	40	40
Bihar	44	43

Source: PFC report on performance of state power utilities; Planning Commission annual report on functioning of DISCOMs.

Delays in receiving subsidies, coupled with delays in tariff revision and a high level of AT&C losses, put the finances of DISCOMs under severe stress and erodes their working capital. This is one of the main reasons why so many DISCOMs have had to resort to borrowing to finance even their day-to-day operations. Power purchase accounts for around 60% to 70% of expenditure and has a direct impact on cost and quality of supply. In spite of this, almost no state undertakes any scientific demand supply forecast or long-term power-purchase planning. The failure in power-purchase planning has led to a huge gap between demand and supply and large-scale load shedding on the one hand, while buying high-cost, short-term power on the basis of bilateral contracts has significantly increased expenditure on the other.

Figure 1 shows the quantum of high-cost power purchased by some of the debt-ridden states in FY 12. Even with a modest difference of Rs 1.5/unit in the rates of long-term contracted power and short-term bilateral power, if a DISCOM buys 5,000 million units (roughly corresponding to a capacity of 800 MW) of short-term power, it incurs an additional expense of Rs 750 crore. If the DISCOM buys 20% to 25% of its power requirement from such costly sources and finances it through short-term borrowings, while not even being able to recover the average cost of supply, it is only natural that its financial situation will be seriously jeopardised.

Figure 1: Proportion of High-Cost, Short-Term to Total Power Purchase (%)



Interestingly, there are clear provisions in the EAct as well as SERC regulations to tackle such situations. Section 65 of the EAct empowers SERCs to demand advance payment of subsidies from state governments. However, no SERC has made use of this provision. Further, most SERCs have a cap on the quantum or cost of short-term power purchases under their tariff regulations. Besides,

the multi-year tariff regulations of almost all SERCs have provisions for formulating and reviewing power procurement plans, making it possible to avoid high-cost, short-term power purchases. So, it is evident that the issues that are at the root of the present debt crisis could have been dealt with if the prevailing laws and regulations had been followed. Thus, the main failure is the non-implementation of these laws and regulations by the authorities concerned, which includes SERCs, DISCOMs and state governments.

An important issue that remains unaddressed in the present public discourse on debt restructuring is the lack of accountability of the banking sector. There is nothing new about the precarious state of DISCOM finances. But in the absence of audited accounts, or non-payment of subsidies by state governments, or tariffs not being revised for years, why did banks keep lending to DISCOMs till the situation reached a crisis levels? Had the banks followed prudent practices and stopped lending sooner, the quantum of losses, and hence the bailout, would have been substantially smaller. The Ahluwalia Committee report very presciently talks about the risk of moral hazard in any bailout, as it encourages delinquent behaviour, and one can easily relate it to the banking sector's behaviour in this case. Sadly, the present FRP does not even mention the responsibility of banks in this crisis nor does it suggest any measures to reduce the risk of moral hazard. Banks do not seem to face the strong penalties that should prevent such irresponsible behaviour in the future. Thus, if the FRP is accepted and implemented, it will provide short-term relief for the DISCOMs and the lenders, but will not achieve much in terms of preventing such losses in the future.

The losses of DISCOMs began rising from 2005-06 and by 2010, the situation was such that another bailout was unavoidable. Meanwhile, the central government tried several quick fixes to deal with it. The MOP wrote a letter to the APTEL requesting it to take action against the SERCs that had not revised tariffs for a long time. The APTEL converted this letter into a suo motu petition and issued a directive in February 2011 to all SERCs on ensuring tariffs were revised on an annual basis. However, in its directive, the APTEL had nothing to say about the absence of accountability in power-purchase planning or the lack of transparency in load-shedding. It also said nothing about the blatant non-compliance of SERCs with Section 59(2)(b) of the EAct, which requires them to collect and publish information on the compliance of DISCOMs with standards to improve supply and service quality. In November 2011, a circular was issued by the MOP to all SERCs, instructing them to implement open access in accordance with its and the Planning Commission's interpretation of the EAct. From these actions, it is clear that the centre sees tariff revision as the only measure to curb losses. However, this narrow focus on financial viability has made it lose sight of fundamental governance issues such as long delays in SERC appointments and the delivery of services to the poor.

Addressing Institutional Accountability

It is true that in the short-term there is no alternative but to finance this bailout. Since the state governments are largely responsible for the problem, it is appropriate that they bear most of the burden. But, in the long term, there is a need to address the issue of institutional accountability that is at the root of this crisis. This analysis highlights a failure in accountability at multiple levels – DISCOMs, SERCs, state and central governments, and banks. In spite of there being clear legal provisions, these institutions failed to ensure their implementation and that led to the present crisis.

Yet, the bailout could have been an opportunity for the central government to improve the basic accountability of state institutions. This could have been achieved in several ways. For example, imposing mandatory conditions for the timely appointment of SERC members and chairpersons, or operationalising open access so that low-cost power becomes available to small consumers. While encouraging timely tariff revision, it was possible to mandate measures that would ensure an improvement in supply and service quality to rural and poor households. Third-party monitoring under the FRP should not be limited to reviewing AT&C losses and metering status, but also look at broader issues such as rural hours of supply, capex plan implementation, transparency in load-shedding, and so on. The SERCs should be mandated to issue transparent and accountable load-shedding protocols and to ensure compliance with the provisions in the EAct related to supply and service quality. Unfortunately, the FRP neither tries to address the issues that are at the root of the present crisis nor does it ensure implementation of any pro-poor or pro-equity provisions. Merely focusing on regular tariff increases without addressing fundamental institutional issues, coupled with the risk of moral hazard of banks, may lead us to yet another bigger bailout in future. Finally, while the present crisis is bad enough, what is worse is not using it as an opportunity to avert future ones. It will be very unfortunate if we have to wait for yet another crisis to ensure the proper functioning of the very institutions that govern the sector.

NEW

Web Exclusives

EPW has introduced a new section, "Web Exclusives" on its new and improved website (http://www.epw.in).

This section will feature articles written exclusively for the web edition and will normally not appear in the print edition. All visitors to the website can read these short articles written mainly on current affairs.

Readers of the print edition are encouraged to visit the *EPW* website and read these web exclusives which will see new articles every week.