Pakistan Power Sector

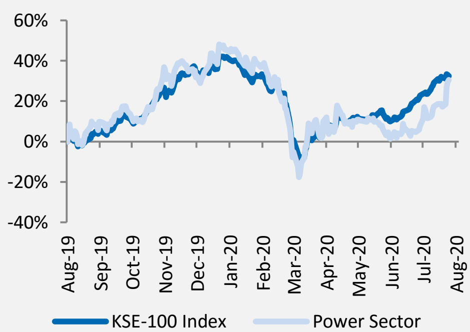
MOU signed with 2002 Policy IPPs

17-Aug-20

Sector Performance

	Absolute %	
24.6	21.6	30.5
1M	3M	12M
14.6	2.4	(1.9)
	Relative to KSE %	

Power Sector vs. KSE-100 Index



TP	Previous	Revised	% change
NPL	29	28	-3%
NCPL	31	30	-3%
HUBC	179	172	-4%

- **The government and power producers, established under 2002 policy, have signed a Memorandum of Understanding (MOU) to bring down the power tariff.**
- **Under the MOU, ROE for local investors has been revised upwards to 17% from 15% while USD indexation has been fixed at 148. For foreign investors ROE has been fixed at 12% per annum.**
- **The interest rate earned on overdue receivables has been revised from flat KIBOR+4.5% to KIBOR+2% for the first 60 days after they become overdue and KIBOR+4.5% thereafter.**
- **Furthermore, an agreement has been reached for sharing of fuel efficiency gains and O&M savings.**
- **The government has also future move to Take and Pay basis from Take or Pay basis, whereby this development would help in reducing the capacity payments for the government.**
- **The MOU has made some notable changes in the PPA which would have a negative impact on 2002 policy IPPs such as NPL, NCPL, HUBC Narowal and EPQL.**
- **It has become clear from this agreement that the government is taking serious measures to curb the accumulation of circular debt and it will adopt a similar stance for negotiations with power projects falling under 1994 policy and 2015 policy umbrella.**

MOU between government and IPPs signed: The government and power producers established under 2002 policy have signed a Memorandum of Understanding (MOU). To highlight, IPPs have been in the limelight for making excess profits and putting undue pressure on the country's resources. The government has been in discussion with IPPs to renegotiate the Power Purchase Agreements (PPA) in order to reduce the accumulation of circular debt. The signing of MOU with IPPs falling under 2002 policy is the first step and amendments are expected for IPPs established under 1994 policy and 2015 policy as well.

Terms of the MOU: The MOU has proposed the following changes in the PPA of 2002 policy IPPs:

• For oil based projects the sharing of future fuel savings would be on a sliding scale, whereby first 0.5% efficiency improvement above benchmark efficiency would be shared 70:30 in favor of the government, 60:40 for the next 0.5% improvement in efficiency, followed by 50:50% for next 0.5%, and finally 40:60 for any efficiency above that. Furthermore, the government shall not share any efficiency losses.

• Any O&M savings in the future will be shared 50:50 for oil based power producers after accounting for any reserves created, or to be created, for major overhauling, to be reviewed by power purchaser or NEPRA as mutually agreed.

• For gas based projects fuel and O&M shall be taken as one consolidated line item and any future net savings shall be shared 60:40 in favor of the government and IPP, respectively.

• In order to ensure that the actual efficiency is matching the efficiency reported in the financial statements, the government shall appoint an independent consultant to perform a one-time detailed heat rate test for all

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	FY21F	FY22F	FY23F
NPL			
Old EPS	5.02	5.03	5.02
New EPS	4.75	4.56	4.4
% change	*-5.4%*	*-9.4%*	*-12.2%*
NCPL			
Old EPS	5.79	6.3	7.13
New EPS	5.47	5.71	6.29
% change	*-6.0%*	*-9.0%*	*-12.0%*
HUBC (Narowal)			
Old EPS	2.23	0.67	0.71
New EPS	2.11	0.60	0.62
% change	*-5.3%*	*-9.7%*	*-12.5%*

IPPs, for which the GoP and IPPs' representatives shall agree on the TORs, standards and corrections required.

• With regards to overdue receivables from the government, for all future invoices, Delayed Payment Rate (DPR) under the PPA shall be reduced to KIBOR + 2% for the first 60 days after the due date, and thereafter at KIBOR + 4.5% as per the PPA.

• The ROE including ROEDC for local investors shall be changed to 17% per annum from 15% per annum in PKR on NEPRA approved equity at COD calculated at USD/PKR exchange rate of PKR 148/USD, with no future USD indexation. For foreign investment registered with SBP, ROE and ROEDC will be 12% per annum.

• The Government of Pakistan shall actively support the creation of competitive power markets. All projects shall convert their contracts to Take and Pay basis, without exclusivity, when Competitive Trading Arrangement is implemented and becomes fully operational, as per the terms defined in the license of each IPP. In the interim period, CPPA (G) shall work towards providing access to the bilateral market at the earliest.

• The Power Purchaser and GOP shall devise a mechanism for repayment of the outstanding receivables with agreement on payment of receivables within an agreed time period which shall be reflected in the final agreement to be signed. The power purchaser shall ensure adherence to its contractual obligations.

• In order to assess if a company has made any excess profits, the reconciled numbers between the Committee and the IPPs engaged in this exercise, shall be submitted to NEPRA. As a legal body vested with the authority for tariffs, NEPRA shall hear and decide this matter in accordance with the 2002 Power policy, tariff determination and PPA, and provide for a mechanism for recoveries, where applicable.

Impact on the power sector: The MOU has made some notable changes in the PPA which would have a negative impact on 2002 policy IPPs such as NPL, NCPL, Narowal and EPQL. Firstly, the removal of USD indexation from ROE removes the dollar hedge provided by the power sector, which was one of the main attractions of the sector. Even though, the upward revision of the ROE component will be contain the reduction in USD indexation, in the upcoming years the removal of USD indexation would result in earnings contraction.

The proposal for sharing of fuel and O&M savings would have a negligible impact on BIPLS Power universe since these IPPs have now also become inefficient. Furthermore, the downward revision of the interest rate of overdue receivables would reduce the penal income earned by the power companies, further putting downward pressure on the earnings.

The MOU also states the conversion of PPAs from Take or Pay to Take and Pay in the future. This, when implemented, is going to be a fairly negative event for IPPs since due to the addition of coal power projects the load factor for IPPs under 2002 policy has declined significantly.

Even though the MOU mentions the settlement of circular debt for the IPPs, it does not provide any framework or timeline for the process. We highlight that any settlement of overdue receivables would help alleviate the liquidity

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pressures on the IPPs and reduce reliance on ST borrowings to fund operations, whereby overdue receivables for BIPLS Power universe stand at PKR221bn.

Investment perspective: The MOU has made it clear that the government is taking serious measures to curb the accumulation of circular debt. Since this MOU has only covered IPPs that fall under 2002 policy, further changes can be expected for 1994 policy and 2015 policy IPPs. As noted above, the removal of USD indexation will reduce the attractiveness of the power sector for investors. Furthermore, if the government changes the agreements to Take and Pay, it would further reduce the earnings of the power sector as the country currently has excess generation capacity.

For KAPCO, which is currently awaiting renewal of its PPA, it is a sign of the times to come. The company can expect the new PPA to be Take and Pay, dollar indexation fixed at 148 and probable removal of guaranteed fuel supply. All such measures would result in decline in earnings. However, any settlement of overdue receivables would be a positive event for the company whereby net receivables (net of payables and ST borrowing) for KAPCO stand at PKR53/sh.

According to news reports, IPPs formed under the 2015 policy may see a change in their debt tenure from 10yrs to 25yrs. This would help reduce the power tariff. Since many CPEC projects fall under 2015 policy it remains to be seen whether China would agree to a fixed dollar rate. If this change is accepted it would impact HUBC, ENGRO and LUCK power projects.

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