Policy Analysis

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Going In Circles

Misconceptions about circular debt

There are certain misconceptions about the power sector's circular debt, which has generated controversy in the country.

Contrary to various official claims, circular debt in power sector cannot be resolved on a permanent basis unless we take some radical measures. Initially, we need to change our energy mix to reduce dependency on oil-based electricity, and take stern actions to stop electricity theft.

Pakistan's energy mix of electricity is highly skewed and dependent on thermal generation (oil and gas). According to official estimates, 36 per cent of our electricity is produced from oil, another 36pc from hydel, around 25pc from gas and only 3pc from nuclear. This reflects that the cost of electricity would increase with an increase in global oil prices.

Chain of Supplies

There are at least a dozen entities involved in circular debt. Oil and Gas Development Corporation (OGDC) and Pakistan Petroleum (PPL) provide crude oil to refineries, including Pak Arab Refinery (PARCO), Pakistan Refinery (PRL), National Refinery (NRL), Attock Refinery (ARL), and BYCO Petroleum, who sell oil to Pakistan State Oil (PSO).

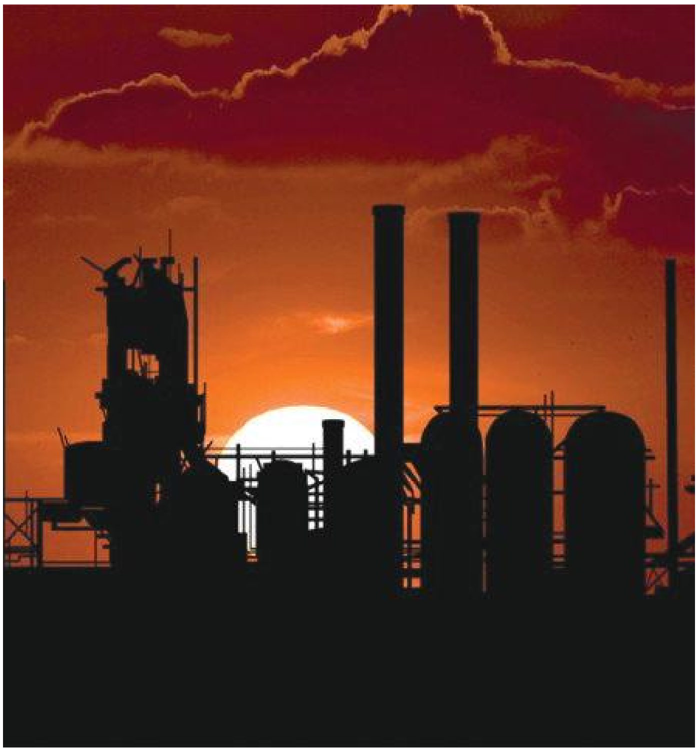
The Government of Pakistan (GoP) has to receive petroleum levy (PL) and crude discount (CD) from the refineries. PSO buys oil from refineries and supplies it to power generation companies (GENCOs). Then comes power distribution companies (DISCOs) that buy electricity from GENCOs and sell it to the consumers.

GENCOS dilemma

The average crude oil prices (OPEC basket) remained $112 per barrel during August 2011 to April 2012 during the last nine months. High prices of crude oil have increased per unit cost of electricity. Power generation companies are unable to recover their cost of production (partly due to power theft and partly due to high prices of oil). They are not in a position to pay to PSO, so PSO cannot pay to refineries, which cannot pay to OGDC, PPL, and GoP and this cycle continues. Thus, it is important to take some radical measures if we want to permanently get rid of circular debt issue in the medium to long-term.

PARCO – the only loser

Unlike the common perception, all the above-mentioned entities involved in circular debt chain are not negatively affected by it whereas a few of them are actually making profits. In my opinion, PARCO is the only loser among refineries. It has to receive Rs 29.10 billion from PSO and pay Rs 19.25 billion to GoP, OGDC, and PPL. All other refineries have to pay much higher than their receivables. BYCO, for example, has to receive Rs2.65 billion from PSO and pay Rs12.13 billion. Similarly, ARL has to receive 29.03 billion from PSO and pay 37.10 billion.



How to clean up the balance sheet?

Contrary to the belief that GoP would not be able to retire the existing circular debt due to lack of fiscal cushion, GoP can clean up the balance sheet of 10 major organizations in the liquid energy supply chain by approximately Rs700 billion without any monetary loss.

One can start from Pakistan State Oil which has to receive Rs200 billion from power sector. As it has cash flow problems, so it cannot make payments to refineries on time. With the limited oil stocks, it cannot sell (on deferred payment) to PEPCO, HUBCO and KAPCO, which would not be able to generate electricity, thus resulting in load-shedding.

Against the current receivables of Rs200 billion from power sector, PSO has to pay Rs85 billion to refineries. The shortfall in PSO (mainly to retire letters of credit) is financed by bank borrowing. PSO pays around Rs 10 million per month as cost of borrowing.

The refineries, which have to receive Rs85 billion from PSO in turn, need to pay Rs 101 billion to GoP, OGDC, and PPL. The refineries are not paying their dues using the plea that they have a cash flow problem due to non-payment from PSO.

Direct GoP receivable (petroleum levy and crude discount) from refineries (BYCO, PARCO and PRL) as on 23rd April 2012 was Rs18.3 billion. The idea is that GoP should pay the amount equivalent to PL and crude discount (Rs18.3 billion) to PEPCO through National Bank of Pakistan as mediator. PEPCO would pay to HUBCO and KAPCO and the three would pay to PSO. The PSO, in turn, clears all outstanding of BYCO, and make partial payments to PARCO and PRL. The refineries would clear up GoP. The GoP would get its Rs18.3 billion back in less than an hour.

In the second step, GoP shall arrange a loan from banks (or through term finance certificates) equivalent to the amount that PSO owes to refineries and those that refineries owe to OGDC, total of whichever is lower. This loan (Rs59.65 billion as per the working on 23rd April 2012) would be paid to PEPCO. PEPCO would pay to HUBCO, KAPCO, and PSO. HUBCO and KAPCO would also pay to PSO. PSO, in turn, would pay to the five refineries. Refineries would make the payment to OGDC.

The GoP has 74.97pc of shareholding in OGDC. Unappropriated profits of OGDC is Rs179 billion. It has a dividend paying capacity of 42 per share. OGDC would use the amount received from refineries to pay dividend of up to Rs18.5 per share. The GoP shareholding in OGDC will result in GoP receiving dividend of Rs59.65 billion. This dividend may be used to pay back the loan amount that GoP initially mobilized to pay to PEPCO.

These two steps would help PSO to recover around Rs77.95 billion from the power sector. It would reduce PSO's payable to refineries to Rs7 billions. It would also clear refineries' payable to GoP (PL and crude discount). OGDC's receivable would come down from Rs75.78 billion to Rs16.13 billion. The balance sheet of 10 organizations in the liquid energy supply chain will be cleaned up by approximately Rs700 billion. Settlement of refineries' receivable balances will result in increased business with PSO. Clean up balance sheets will help increase the stock price of all the listed entities currently affected by circular debt. This would help in presenting a positive picture to international lenders on power sector circular debt situation with no extra burden on the state kitty.

This formula does not address Rs 6.05 billion that the refineries have to pay to PPL. However, ARL (that has to pay Rs4.6 billion to PPL) and PPL can sort it out using ministry of petroleum and natural resources as third party mediator.

The details of above-mentioned formula prepared by PSO finance department and approved by PSO Board of Management have been shared with high-ups by Minister of Petroleum (I believe that a presentation was made to President of Pakistan on this issue). I hope our economic team would analyze its pros and cons to reduce the burden of circular debt. Having said that, we should remember that there is no permanent solution to circular debt unless we bring radical reforms in the power sector, including a change in our energy mix.

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