



Opinion

23-Jun-11

Analysts

Rana Muhammad Nadeem
(+92-42-3586 9504)
nadeem@pacra.com

Samiya Mukhtar
(+92-42-3586 9504)
samiya@pacra.com

Awais Khan
(+92-42-3586 9504)
awais@pacra.com

PAKISTAN'S POWER SECTOR, STRUGGLING FOR POWER

Pakistan is passing through difficult economic times. Our products face stiff competition in the global space, which is further accentuated due to inefficiencies being created by infrastructure bottlenecks - particularly the power shortage. At the same time, war on terror has led to weak law and order situation. Under the circumstances, the government finds it difficult to enhance its fiscal space. Meanwhile, no letup is available in strict monetary policy due to stubborn inflation - mainly due to rising commodities' prices.

Our woes are aggravated by constrained power supply. While our power infrastructure has capacity issues, the available capacity cannot be fully utilized as well. This is mainly due to sizeable gap between the volume of electricity generated and eventually billed. The situation is worsened by a misdirected subsidy structure. These factors have created sizeable financial mismatch, being filled by the government. GoP, with all its good intentions and efforts but constrained by its limited fiscal space, finds it difficult to fully meet the needs. This has led to creation of "circular debt", where the difference between cost of electricity produced and recovered from the consumer is floating throughout the power sector. The impact subsides with sporadic injection of money by GoP, but it recreeps soon as the gap between electricity cost and consumer proceeds, though narrowing, is still there.

Pakistan's power generation has two key sources, hydel and thermal. In this regard, Independent Power Producers (IPPs), with commencement of a large number of plants in the recent past, now contribute significantly towards total electricity production. However, these are hit hard by accumulation of circular debt.

This has resulted in pile up of huge receivables from power purchaser. Resultantly, many of the IPPs are facing severe pressure on cashflows. This severity is more pronounced in case of new IPPs, which have limited contingency reserves. Notably, these payments are critical to ensure timely repayment of borrowings.

PACRA rates ten IPPs and considers the guarantee of the GoP against capacity and energy payments as one of the key rating factor. The funding structure of IPPs is such that major portion of the project is financed through debt. The guaranteed payments by the GoP includes the debt portion, thereby transferring the financial risk to the sovereign, given all performance parameters under the PPA are met. The non-payment by the power purchaser is not only putting operational pressure on IPPs but may result in increased financial risk. Few IPPs are expected to handle the immediate pressure, but in



most cases the repayment of debt obligations is entirely contingent upon release of overdue to the affected IPPs.

Gradual removal of subsidies in the power chain, ongoing restructuring of distribution companies to minimize losses, and improved financial discipline are expected to help in overcoming circular debt and related issues. However, the roadmap and milestones are still blur. We believe that despite all its financial problems, GoP would not let any such situation to arise resulting in closure of an IPP due to non-payments, in turn, sovereign default. However, the payment pattern is likely to remain erratic. We have observed such instances lately, wherein a few IPPs have to invoke government guarantee for settlement of overdues. The invocation was then withdrawn due to partial payment by the GoP.

In this regard, PACRA would continue to monitor all the developments related to the circular debt issue and would take the appropriate rating action on individual entities as and when required.

Disclaimer

This press release is being transmitted for the sole purpose of dissemination through print/electronic media. The press release may be used in full or in part without changing the meaning or context thereof with due credit to PACRA.

The primary function of PACRA is to evaluate the capacity and willingness of an entity to honor its obligations. Our ratings reflect an independent, professional and impartial assessment of the risks associated with a particular instrument or an entity.

PACRA's comprehensive offerings include instrument and entity credit ratings, insurer financial strength ratings, fund ratings, asset manager ratings and real estate gradings.

PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.