ENERGY AND MINING SECTOR BOARD DISCUSSION PAPER

PAPER NO.14

MAY 2005

Lessons from the Independent Private Power Experience in Pakistan

Julia M. Fraser

THE WORLD BANK GROUP

The Energy and Mining Sector Board

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CONTENTS

FOREWORD

As part of the World Bank's ongoing work to identify barriers to increased investment in the power sector in developing countries this paper was produced as a case study on workouts for projects under stress.

Pakistan's first private power project, the Hub Power Project, and its subsequent 1994 private power policy – both supported by the World Bank – were lauded by the international investment community. Pakistan succeeded in attracting over $5 billion in investment and contracting about 4,500 megawatts of private generation in record time. However, macroeconomic instability in the country and financial problems in the power utility revealed some of the shortcomings in the policy and its implementation. Unilateral attempts to terminate and re-negotiate IPP contracts led to a tumultuous three year workout period. The Government, project sponsors and lenders all looked to the World Bank Group during this critical time as it was heavily involved in providing financing and guarantees to more than half of the IPPs under construction or operating in Pakistan at the time. The Bank Group was credited with facilitating an orderly resolution of the IPP disputes and helping to avert a wider Government default on IPP contracts which could have had macroeconomic implications for Pakistan. Several lessons that can be taken from the workout experience are highlighted in this discussion paper.

Jamal Saghir
Director, Energy and Mining Sector Board
May 2005

ABSTRACT

The discussion paper recounts the background to the IPP program, describes the "orderly framework" developed by the World Bank Group for the IPP workout, and concludes with several lessons learned. The 1292 MW, $1.6 billion Hub Power Project was hailed as a landmark in the field of infrastructure finance at the time of financial close in 1995. It set an important precedent for the viability of private finance for a major infrastructure project in a developing country. The complex suite of documentation developed together with experience gained by Pakistan officials and institutions during its six years of project development led to the adoption of a Private Power Policy in 1994. Under this policy, 19 independent private power projects (IPPs) reached financial close in record time for an additional 3400 MW. (Four projects, totaling 435 MW were subsequently terminated.) Pakistan earned high praise amongst international developers and financiers and was a model for private sector development in the power sector in the mid 1990s. It was described as "the best energy policy in the whole world" by the US Secretary of Energy following a trip to Karachi in September 1994. That same year, the Hub Power Project was named project finance "Deal of the Year" by Euromoney Institutional Investor. However, by 1998 the Government had issued notices of intent to terminate 11 IPPs, representing two-thirds of private power capacity contracted, on alleged corruption and/or technical grounds. Perceptions by the project sponsors of excessive coercion, harassment and heavy-handed legal and other actions initiated by the Government to renegotiate tariffs or cancel contracts contributed to Pakistan's fall from grace in the eyes of the international private sector community. A turbulent three year work-out period followed where most contracts were ultimately re-negotiated which coincided with the period when Pakistan was brought to the brink of financial collapse.[1]

The World Bank Group played a pro-active role in facilitating the resolution of the IPP disputes, necessitated by its large financial role in the IPP program, and assisted in preventing the crisis from exploding further. The work-out strategy called for the Government to separate criminal allegations from commercial disputes with the former to be resolved through the legal system and the latter through amicable negotiation. Several important lessons can be drawn from the Pakistan experience. Setting a bulk tariff ceiling allowed Pakistan to alleviate its power shortage through private generation in record time; however, too much power was contracted with little regard for least cost expansion. The scale of private investment in generation should be aligned with the country's state of development with respect to sector reforms and also social, economic, political and institutional governance. In addition, solicitation of IPPs should be on a competitive basis and staggered over a few years so that changes in international investors' assessment of country and contract risks could lead to declining bid prices. Staggering IPP solicitation and scaling down large IPP capacity would also allow the utility to re-assess demand/supply conditions and adjust the contracted capacity and completion timing for subsequent IPPs accordingly. Since assumed future country conditions at appraisal can be substantially different from what actually emerges, it is important that a transparent bidding process is followed to be more politically sustainable. Finally, while the risk of re-negotiation can be minimized by competitive bidding and transparent contracts, this risk cannot be wholly avoided. All parties have to recognize that re-negotiation is reasonable provided it is done in a mutually acceptable manner.

[1] Following Pakistan's nuclear tests and the subsequent imposition of economic sanctions in May 1998, Pakistan's economic and balance of payment situation deteriorated rapidly and foreign investment slowed to almost nothing. Within just a few weeks, the stock market declined by 40%, the free market rupee depreciated by more than 25% against the US dollar, and official reserves declined to less than 2 weeks of imports. In early 1999, Pakistan signed an agreement with the Paris Club for rescheduling of $3.3 billion of public and publicly guaranteed debt repayments.

ACKNOWLEDGEMENTS

This paper draws on previous analytical work and internal memoranda prepared by Bank staff and consultants in the Energy Network and the South Asia Energy Unit. Valuable comments were received from several colleagues, including Penelope Brook, South Asia Energy Sector Manager, Tjaarda Storm van Leeuwen, Lead Financial Analyst, Middle East and North Africa Energy Unit, of the World Bank and from Apinya Suebsaeng, Senior Manager, Credit Review and Portfolio Division, and Denis Carpio, Chief Evaluation Officer, Operations Evaluation Group of the International Finance Corporation. In particular, the author acknowledges Mr. Carpio's contribution to the description of lessons learned described in the abstract.

ACRONYMS AND ABBREVIATIONS

GOP	Government of Pakistan
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IPP	Independent Power Project
JEXIM	Japan Export-Import Bank
KESC	Karachi Electricity Supply Corporation
kWh	kilowatt hour
LTCF	Long Term Credit Fund
MIGA	Multilateral Investment Guarantee Agency
MW	Megawatt
PPA	Power Purchase Agreement
PPIB	Private Power and Infrastructure Board
PSEDP	Private Sector Energy Development Project
Rs.	Rupees
WAPDA	Water and Power Development Authority

SECTOR BACKGROUND

Beginning in 1987, Pakistan requested assistance from the World Bank to increase private sector participation in the energy sector. An initial framework of incentives to attract private investment in the energy sector was put in place in 1988 which addressed the following constraints:

- The absence of a comprehensive policy framework concerning incentives, fiscal treatment, repatriation of profits and capital, availability of foreign exchange, and pricing;
- The lack of long term financing for projects with long gestation periods and economic life; and
- The inadequacy of the institutional arrangements for the review, negotiation and approval of private sector projects.

In July 1992, the Government of Pakistan (GOP) adopted a Strategic Plan for power sector privatization. Under this plan, the Water and Power Development Authority (WAPDA), the main electric utility in the country, would be unbundled into separate generation, transmission and dispatch, and distribution companies and gradually privatized. The private sector would be invited to construct and operate new thermal generation plants, and an independent regulator would be established.

BANK SUPPORT FOR PAKISTAN'S PRIVATE POWER POLICY

In support of this policy, the World Bank approved the US$150 million Private Sector Energy Development Project (PSEDP 1) in June 1988. Its objectives were to: (i) assist Pakistan in mobilizing, from the private sector, the resources required to meet the anticipated deficit in power supply; (ii) establish incentives to encourage private sector participation; and (iii) establish an institutional framework required to facilitate private sector transactions in energy on a sustainable basis. The Second Private Sector Energy Development Project (PSEDP II) was approved in November 1994 for US$250 million. It replenished the Long Term Credit Fund (originally known as the Private Sector Energy Development Fund) established under the first project (PSEDP I), with the objective of continuing to (i) assist the Government in mobilizing additional private sector resources; and (ii) build on the institutional and policy framework established to facilitate private sector participation in the energy sector.

Although the international development community had come to realize that the role of the public sector needed to be redefined and reduced, no other low-income country had made private investments a corner stone of its energy policy. This strategy was a reflection of hard economic realities: a non-sustainable fiscal deficit; a serious balance of payment situation; and the inability of the public sector to mobilize the funds required to make the investments needed to keep pace with power demand (which was growing around seven percent per year). However, even if sound demand management policies had reduced the growth of electricity demand below seven percent, the Government's strategy to rely increasingly on private investment in power was relevant as budgetary resources were needed to meet Pakistan's pressing social needs. PSEDP I and II were designed to support the implementation of a program of agreed measures that consisted of: (i) policies for the promotion of private sector investment in energy; (ii) creation of a vehicle to provide long-term financing for private energy projects; and (iii) establishment of new institutions for the evaluation, negotiation, and approval of private energy investments.

PSEDP I and II represented a major shift in the Bank's power sector lending policies in Pakistan. They embedded the lessons drawn from Bank lending to government utilities, as reflected in the Policy Paper entitled "Bank Lending for Electric Power" (1993). The Projects, however, were demanding as they required *inter alia*: (i) the Government and its agencies to learn and adapt policies to enable private sector transactions in power; (ii) the creation of three new entities, namely the Private Power and Infrastructure Board (PPIB) – the "one stop shop" – in charge of negotiating the contractual framework (referred to as the Security Package) on behalf of the Government; WAPDA Private Power Organization (WPPO) in charge of negotiating the power purchase agreements (PPA); and the Private

Energy Division (PED) of the National Development Finance Corporation (NDFC) in charge of administering the funds under the two Bank loans (referred to as the Long Term Credit Fund - LTCF); and (iii) the power utility, WAPDA, to abandon its virtual monopoly on power generation, and adjust its activities including purchasing power from plants it did not own.

The $1.6 billion, 1292 MW Hub Power Project (Hubco) was the first private power project in Pakistan. It was hailed as the project finance "Deal of the Year" by *Euromoney Institutional Investor* in 1994, and later in 1999, selected as the "Deal of the Decade" by the same magazine since it was "still one of the landmark project financings in the last 10 years." The Hub Power Project occasioned many "firsts" for Pakistan, the Bank and the international financial markets. For Pakistan, it was the first private infrastructure project and the first limited recourse financing. For the Bank, it was the first private infrastructure project, Bank-financed infrastructure fund (the LTCF) to support private projects, partial risk guarantee under the Expanded Co-financing (ECO) program, ECO guarantee with another institution (JEXIM), and the use of the ECO program to support a private project. For the financial markets, it was the first major private infrastructure project in a sub-investment grade developing country to be financed by international commercial banks on a limited recourse basis, the first international equity offering (global depository receipt) and underwriting for a developing country infrastructure project under construction, and the first stock market floatation of a single power station under construction.[2]

1994 PRIVATE POWER POLICY

Although the complex suite of documentation[3] negotiated during the Hub Project laid the foundation for the model agreements under the 1994 Private Power Policy, the Government recognized the need to fine-tune the incentive framework to take into account the feedback received from private investors and the international financial community. Refinements in the framework were also needed to make Pakistan internationally competitive in attracting financial resources, and to integrate these measures with the actions taken by the Government to deregulate the economy and increase reliance on the private sector. The result was a new policy for private power ("Policy Framework and Package of Incentives for Private Sector Power Generation Projects in Pakistan"), promulgated in March 1994 (hereto referred to as the 1994 Private Power Policy), which incorporated the original policies introduced in 1988 together with subsequent modifications. The 1994 policy was hugely successful in attracting the private sector. GOP issued Letters of Support to 34 projects for more than 9,000 MW under the expectation that less than 50% of the projects would make it to financial closure. Including Hubco, 20 IPPs with a total installed capacity of about 4,500 MW reached financial close, of which four totaling 435 MW were later terminated. The total investment was about US$5.3 billion, of which 25% was financed by foreign equity. An estimated US$3 billion was financed with foreign exchange debt with an average maturity of 10 years. Roughly 85% of the foreign debt or 66% of total debt was from official sources.

Despite the problems in the IPP program (discussed below), Pakistan was successful in attracting foreign capital in a quick, efficient manner. While the first IPP, Hub Power, took almost eight years to reach financial close, the IPPs under the 1994 policy closed on average in two years. The reasons for its initial success included: (i) having a clear framework as documented in the 1994 Private Power Policy; (ii) establishing an indicative bulk tariff in the policy with indexation mechanisms for fuel and inflation; (iii) attractive fiscal incentives; (iv) standardized security package; and (v) creation of a "one stop shop" for investors. (See Box 1 below for a description of the salient features of the 1994 Policy.)

CRITIQUE OF THE IMPLEMENTATION OF THE 1994 PRIVATE POWER POLICY

In hindsight, the selection criteria under the 1994 Policy enabled the implementation of many subprojects which were not consistent with the least-cost expansion program in terms of: (i) capacity and location (too small given the system size and requirements and not

[2] M. Gerrard, "Financing Pakistan's Hub Power Project: A Review of Experience for Future Projects", August 1997, sponsored by the Project Finance and Guarantees Department, World Bank.

[3] About 200 separate original project agreements and documents were drafted and negotiated as part of the Hubco project. In addition, many documents had to be drafted and negotiated twice as the circumstances changed, i.e. changes in government, sponsor group, or construction group.

suitably located to system requirements); (ii) fuel selection (excessive reliance on imported fuel oil, as opposed to domestic natural gas although at the time gas allocation for power was difficult to secure and overall gas reserves were thought to be on the decline); and (iii) technology (too many diesel sets and steam turbines, as opposed to efficient combined cycle plants). One could argue that had the implementation of the 1994 Policy been limited to about 2,000 MW – as advised by the Bank Group – WAPDA may have been better able to absorb the capacity charges under the long term power purchase agreements, despite the fact that demand for power increased at a slower pace than anticipated resulting in excess capacity for several years. However, there was no clear mechanism for GOP to prioritize projects. The basis on which projects were selected and accorded attention was not transparent and subject to political influence which led to perceptions of corruption by successive governments. Rather than proceed through competitive bidding for private power, Pakistan instead set a tariff ceiling for investors in an effort to accelerate the private power program. This proved very successful in terms of projects being able to reach financial close in a relatively short period as mentioned earlier. The ceiling price set in the 1994 Policy (US cents 6.1/kWh as an average for the first ten years and US cents 5.5/kWh over the life of the project on a levelized basis) was competitive with levelized prices in other developing countries at the time, including Indonesia, Philippines and India.[4]

Some people alleged that by setting a tariff ceiling, the Policy did not provide an incentive for project promoters to reduce costs. The assumed project cost under the 1994 Policy was US$1,000 per kW, but starting about 1997, capital equipment costs for combined cycle plants dropped to about US$450 to US$600 per kW. Pakistan's gas-rich neighbor, Bangladesh, was able to contract a 360 MW gas-fired, combined-cycle plant at around this time for less than 3 US cents per kWh through a competitive tender. Although not a fair or accurate comparison, this was used as an example by Pakistan authorities that they had paid too much. In fact, subsequent analysis revealed that the price in Bangladesh and Pakistan were broadly comparable after adjusting for various factors, including difference in fuel cost and technology costs available during 1994-96 when Pakistan's IPPs were contracted. Nonetheless, the public and political perception was that the cost of private power is too expensive – an important factor when it came to re-negotiation.

Another contributing factor to the implementation problems of the 1994 Policy was the slow pace of the restructuring and privatization of WAPDA and the creation of a suitable regulatory system in comparison to the speed with which the private power program was implemented. The mix of private generation and monopoly public sector transmission/ distribution, and the introduction of private power under the 1994 IPP Policy rendered the sector vulnerable to financial shocks and external events such as changes in fuel prices. While the Bank promoted measures for sector management and restructuring, as well as public sector policy reforms, including introduction of pass-through mechanisms for cost of fuel and power purchased, they were not implemented at the intended pace. The delays in sector reforms adversely impacted the efficiency of both WAPDA and the IPP program, and left the sector overly vulnerable to economic downturns.

BANK GROUP INVOLVEMENT IN IPPS

IBRD provided partial risk guarantees to two projects: Hub Power Co. for US$240 million (reduced to US$137million) and Uch Power Ltd. for US$75 million; IFC provided A- and B-loans as well as equity to five projects for about US$378 million; and MIGA extended guarantee coverage to three projects for a total of US$31 million. In addition, Government of Pakistan provided subordinated loans to four projects through the IBRD-financed Long Term Credit Fund for about US$210 million. In total, the World Bank Group was involved in 11 of the 16 IPPs or 88% of the total IPPs in terms of megawatts (see Annex 1).

IMPACT ON WAPDA'S FINANCES

WAPDA's operating cost structure was transformed by increasing purchases of power from IPPs. With plant load factor assumed at 60%, the share of power from IPPs increased from about 20% in FY97 to 46% in

[4] It is worth mentioning that these prices were not determined competitively, and some of the comparative countries, similar to Pakistan, ranked low on international indices of corruption.

BOX 1. Salient Features of 1994 Policy and Package of Incentives for Private Sector Power Generation

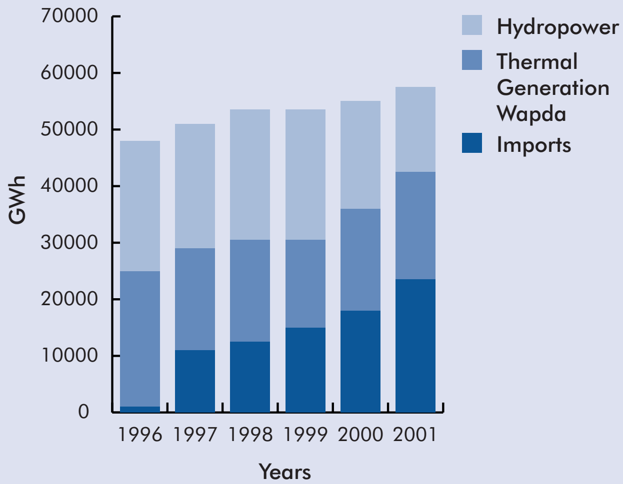
- An indicative Bulk Tariff of US cents 6.5/kWh[a] (to be paid in Rupees) for sale of electricity to WAPDA/KESC, based on annual plant factor of 60%.
- A premium of US cents 0.25/kWh based on energy sold during the first 10 years of project operations was allowed to projects above 100 MW which were commissioned by end 1997.
- Sponsors had to meet the following application procedure for bulk power tariffs:
  – The average tariff for the first ten years does not exceed US cents 6.5/kWh
  – The annual base tariff does not exceed US cents 8.33/kWh in the first year and US cents 6.66/kWh in any subsequent year; and
  – The levelized tariff for the life of the project does not exceed US cents 5.91/kWh (calculated based on a 10% discount rate).
- The actual payment of tariff comprised two components, i.e. a "fixed" Capacity Price and a "variable" Energy Price. As the capacity price is assured as per terms of the Concession Agreements, there was no guarantee for purchase of a specified amount of power.
  – The capacity payment was paid on a monthly basis (Rupees/kW/month) whether the plant generated and sold power or not, provided the plant was available to generate and sell electricity. It covered debt service, fixed operation and maintenance cost, insurance expenses and return on equity. A portion of the capacity fee was fixed throughout the contract life and another portion was subject to escalation for US and Pakistan inflation and exchange rate changes. For purpose of allocating the capacity fee into a per kWh basis (e.g. for determining the average tariff for any year), a plant load factor or utilization rate of 60% was assumed, independent of the actual plant utilization rate.
  – The energy price was a variable amount equal to a US$/kWh variable operation and maintenance component and a pass-through fuel cost component (subject to a maximum guaranteed heat rate/kWh or alternatively, a minimum fuel conversion efficiency rate to electricity) times the actual number of kWh sold during each month. The variable O&M cost was also subject to escalation. There is no guaranteed minimum amount of electricity to be purchased by WAPDA/KESC per month.
- Fiscal Incentives consisting of: exemption from corporate income tax, customs duties, sales tax, and other surcharges on imported equipment.
- Standardized Security Package which includes a model Implementation Agreement, Power Purchase Agreement and Fuel Supply Agreement.
- Creation of a Private Power and Infrastructure Board (PPIB), to facilitate a "one stop" processing of IPP proposals.
- Financial incentives to facilitate the creation of a corporate securities market in the country, including permission for power generation companies to issue corporate bonds and shares at discounted prices, and establishment of an Independent Rating Agency.

[a] The bulk tariff was later reduced to US cents 6.1/kWh with the elimination of the foreign exchange risk insurance scheme.

Source: "Policy Framework and Package of Incentives for Private Sector Power Generation Project in Pakistan", March 1994, Government of Pakistan

FY00 (Figure 1). Between 1996 and 2001, the share of hydropower generation (with its low operating cost) declined from 47% to 29%; electricity tariffs in nominal rupee terms increased by almost 60% but fell in real terms; operating revenue increased by 13% per annum while cash operating costs and debt service increased by 20%; and the cost of private power reached 50% of WAPDA's operating costs. Other developments which contributed to the deterioration of its financial performance included: (i) front-loaded IPP tariffs which are indexed to the US Dollar, combined with a 45 percent devaluation of the Rupee; (ii) a decline in electricity demand due to low economic growth which led to a temporary over-capacity in generation; (iii) poor collection rates from government customers which account for 30 percent of WAPDA's sales; and (iv)

FIGURE 1. WAPDA Energy Generation and Imports



widening tariff cross subsidies that play against industrial and commercial consumers, who installed their own captive capacity.

As a result, WAPDA faced difficulties in meeting its obligations to IPPs which required a discipline of on-time cash payments. This was a new, harsh reality for WAPDA as previous cash flow problems were dealt with through the public sector debt circle where payment arrears to/from other public sector enterprises were a way of life.

THE FALL OF THE IPP PROGRAM

The Government was of the view that further increases in consumer tariffs would be politically difficult if there was no accommodation by IPPs to reduce their price to WAPDA for power purchased. This was especially so given its perceptions that IPP prices were out of line with the international market, that IPPs are very profitable, and that there may have been corruption in some of the transactions approved by the previous elected government. Thus, in 1997 against a worsening fiscal background and unwillingness to adjust retail tariffs, the government attempted to lower IPP payments through various committees of inquiry and sponsor-by-sponsor negotiations. Not only was this unsuccessful, it created confusion and fears of Government not honoring contracts. The Bank received numerous messages that coercive tactics (e.g. arresting/interrogation of IPP company officers and sometimes family members) and threats of project cancellation were being used in attempts to obtain tariff reductions. On the other hand, Pakistani authorities were pressing the Bank to live up to its zero tolerance policy on corruption, and in a specific instance, alleged malfeasance against a former Bank staff member associated with one of the IPPs.

In July 1998, the Government through the PPIB issued seven Notices of Intent to Terminate on grounds of corruption and two on technical grounds which represented about two-thirds of private power capacity contracted. Whatever the substance of the Government's allegations of corruption – such allegations are difficult to prove generally and no evidence was produced in court – these actions were largely perceived by the developers as means to delay the completion of IPP projects[5] under the 1994 Policy and to extort tariff concessions given WAPDA's cashflow problems, political pressure not to increase retail tariffs, as well as the shortage of foreign exchange available in the country. IPPs expressed frustration at being called to appear before no fewer than a dozen IPP Committees constituted by the Government in an attempt to negotiate lower tariffs. The different incarnations of the IPP Committee comprised, at various times and combinations, representatives of the Accountability Bureau, PPIB, WAPDA, Ministry of Finance and independent local businessmen, among others. None of these committees proved effective as no clear authority to negotiate was delegated. In the end, one-on-one negotiations with WAPDA combined with intervention at the highest government level, resulted in several IPPs agreeing to tariff reductions.

Separately, the Hub Power Company was accused of corruption in securing the amendments to the Power Purchase Agreement which resulted in a court mandated reduction in the capacity price to be paid by WAPDA. Hubco denied that corruption had taken place and considered the charges as a means to coerce the company to lower its tariff. Hubco sought assistance in resolving its disputes with GOP and WAPDA through international arbitration but was restrained from doing so through injunctions sought by WAPDA in the local

[5] WAPDA had an inherent incentive to delay the completion of projects since capacity payment obligations did not begin until a project achieved commercial operations.

courts. (A summary of Hubco's legal disputes is summarized in Annex 2.)

Furthermore, changing governments sought to place the blame for the perceived high cost of private power on previous governments, and as a result, the IPP program became highly politicized. The poor initial handling of corruption allegations contributed to the erosion of investor confidence in Pakistan, and foreign investment flowed to a trickle exacerbating the wider economic crisis in the country.

ORDERLY FRAMEWORK FOR IPP WORKOUT

The Bank Group's strategy was to avert a Government default by facilitating an orderly resolution of the immediate disputes and preparing for a permanent solution to the underlying causes of the IPP problem through providing support for the implementation of the power sector reform. One of the basic tenets of the strategy was to persuade the Government to separate criminal allegations (i.e. corruption, bribery, kick-backs) from the commercial issues (i.e. tariff level, liquated damages owed, etc). Following the issuance of Notices of Intent to Terminate, the Bank Group assisted the Government in adopting the so-called "Orderly Framework for IPP Negotiations" in late 1998 to prevent further deterioration in the situation. The immediate step was to conclude voluntary standstill agreements valid for a period of 30 to 45 days so that a meaningful dialogue could commence on all relevant issues without the IPP companies and the lenders being under a threat of termination of the agreements and without government notices giving rise to further defaults and legal proceedings.

The second step was to ensure a fair and just implementation of the IPP contracts whereby the Government would:

- Honor existing contractual obligations.
- Seek a conducive environment for IPP personnel and their families.
- Refer routine disputes including interconnection issues to the technical committee consisting of negotiating agency (e.g., PPIB, WAPDA or KESC), IPP company, and independent engineers/advisors.
- Clarify income and other tax and foreign exchange conversion issues related to IPP contracts.[6]
- Follow due process for settling tax and foreign exchange issues.

The third step was to set a negotiating strategy for different groups of IPPs within the context of sustainability:

- Review actions undertaken in consultation with legal and technical advisors and determine suitable strategy.
- For IPPs without allegations of fraud or corruption or without Notices of Intent to Terminate (NITs) or other legal actions pending:
  - Resolve outstanding contractual issues
  - Negotiate voluntary tariff reduction
- For IPPs where the government considers that credible evidence of fraud etc. is not available:
  - Stop investigations
  - Inform IPPs of this
  - Withdraw NITs
  - Negotiate voluntary tariff reduction
- For IPPs where the government considers that there is credible evidence against them:
  - Quickly complete investigations
  - Conclude standstill agreement
  - Respond to the Companies' and Lenders requests for further information concerning the alleged defaults to facilitate consultation by the Companies as to the cure and mitigation of defaults and allow lenders to exercise their rights in accordance with the Implementation Agreements
  - Initiate legal action against individuals and/or sponsors
  - If necessary conclude second standstill agreement
  - Negotiate voluntary tariff reduction

Bank staff regularly monitored progress in the implementation of the Orderly Framework which was one of the key aspects of the Bank and IMF structural adjustment programs.

RESULTS OF IPP WORKOUT

The financial difficulties of WAPDA were exacerbated by too many IPPs coming on stream simultaneously at a time when demand did not grow as anticipated. This resulted

[6] The Central Bureau of Revenue did not accept the position of IPPs that they were given a certain lower tax rate under the IPP Policy. Several IPPs also reported problems with the timely conversion of Rupees into foreign exchange.

in excess generating capacity that, in the minds of most Pakistan officials, they neither needed nor could afford.

To bring some relief to the cash-strapped power utility, the Government vigorously pursued the renegotiation of tariffs with IPPs. WAPDA also delayed commissioning of several IPPs by not providing them with interconnection facilities or the approval to run their plants until lower tariffs were agreed, saving significant amounts of money in the process. (It should be mentioned that not all delays were a result of WAPDA actions and, in some cases, WAPDA was inadvertently helped by the IPPs themselves when they failed technical performance tests.)

Once the Orderly Framework was accepted by the Government, the basic principles for IPP renegotiation were: (i) contracts are a starting point for negotiation and (ii) negotiations must be by mutual agreement without coercion. Stand-still agreements were signed for all projects which were issued Notices of Intent to Terminate which prevented the companies and/or lenders from undertaking untoward legal steps to protect their rights under the agreements. Importantly, WAPDA also assumed sole responsibility for negotiations addressing the concerns by some IPPs that the parameters were forever shifting with each new IPP committee that was appointed. WAPDA was ultimately successful in securing tariff concessions from about a dozen IPPs, all of which had yet to be commissioned as these were the plants over which WAPDA had the most leverage. Significantly, no IPP (other than Hubco) which had achieved commercial operations prior to this time, conceded to WAPDA's desire to reduce tariffs.

Available data on roughly half of the IPPs which renegotiated their tariff reveals that the average decrease in the levelized tariff was about 10%, ranging from 7-8% to as much as 16%. In exchange for these tariff concessions, the term of their power purchase agreements was extended from around 20 years to 30 years, agreement was reached with WAPDA on the commercial operations date allowing IPPs to begin receiving revenue, and all legal disputes were resolved.

There was little scope for IPPs to dramatically lower their tariffs since the investment in plant and equipment had already been made and projects were close to completion. In addition, by this stage in project implementation, sponsor groups had direct control over only a small portion of costs on which they could negotiate – essentially return on equity and the operations and maintenance cost. Since only 20% of investments were financed through equity, this left little room to maneuver in the negotiating room as project sponsors could not offer reduction in interest rates without lender consent. (In fact, the results of all negotiations were subject ultimately to lender consent.) Lender groups' contribution to the workout often resulted in capitalization of interest and/or debt payments during the early years, and in a few cases, a more extensive restructuring of the amortization profile to meet the revised anticipated cash flows.

It is interesting to note that lenders only agreed to these measures in projects where the plant was delayed in achieving commercial operations – and therefore had incurred significant cost increases (a large component of which was interest during construction costs). Lenders to Hub Power, which had been in commercial operations for a couple years, continued to receive timely debt repayments throughout the dispute period and did not agree to restructure the debt to provide further tariff concessions. It should be noted that Hubco was able to meet their debt payment obligations throughout the workout period despite the fact that WAPDA was not paying the company the full tariff. The company had built up a rather large amount of cash in their accounts since they were prevented from distributing dividends due to a court imposed order. Hubco was therefore able to draw on this cash to meet its debt obligations.

The Hubco case was different from the rest of the IPPs since it did not fall under the 1994 Policy. Government officials alleged that the PPA amendments, which substantially increased the price of electricity produced during the first years of plant operation, were corruptly obtained or otherwise fraudulent. In parallel with legal proceedings related to the dispute playing out in the local courts (see Annex 2), Hubco, the Government and WAPDA held various meetings during 1998-2000 in an attempt to resolve their outstanding issues. At the request of both Hubco and GOP, the Bank facilitated many of these meetings in an attempt to resolve the disputes in a neutral environment. Almost two and a half years after the first allegations of corruption were made, Hubco, the Government and WAPDA agreed to a settlement whereby, *inter alia*, the tariff level was reduced and all criminal and civil cases were disposed.

SITUATION TODAY

Relationships with IPPs have normalized, contracts are being honored, and WAPDA is paying IPPs in accordance with the terms of the PPAs. Nevertheless, all things are not necessarily quiet on the IPP front. While there are no longer high profile disputes, the implications of the cost of IPP power on the financial viability of the power sector, and the question of what customers should be asked to fund through tariffs,[7] remain hot topics in discussions regarding ongoing power sector reforms in Pakistan. This being said, however, it is generally accepted that the IPPs were critical in meeting a severe capacity constraint, and that IPPs and private sector financing have a role to play in meeting the investment gap in the power sector. Since the resolution of the IPP crisis, Pakistan has made the right decisions regarding reform. However, a daunting challenge remains in implementation.

LESSONS LEARNED

The following are some of the lessons learned from the Pakistan experience.

Sector Reform and IPPs.

An impressive amount of resources for the power sector in Pakistan was mobilized over time and helped eliminate power shortages. The IPP program, unprecedented both in concept and scope, elicited an enthusiastic buy-in both within and outside the Bank. The Bank promoted measures for sector management and restructuring, as well as public sector policy reforms, which were generally right and timely. The Government, however, failed to have them implemented at the intended pace. While failures in sector reforms did not precipitate the financial crisis of WAPDA, they compounded it, crippled the efficiency of both WAPDA and the IPP program, and left the sector overly vulnerable to economic downturns.

There is a strong consensus that private investment is not a substitute for reform, and that significant private investment in generation should not take place in front of reforms which at a minimum address distribution efficiency and tariff policies. Private sector participation needs to be conceived and implemented as part of a sensible broader reform framework. For a relatively large power system such as in Pakistan, it would be preferable for an integrated utility sector to be unbundled, so that the power market can be operated in a transparent manner, competition for the market can be introduced and, over time, generating plants can be operated on a competitive basis. In addition, automatic indexation formulae should be in place to protect the purchasing utility from changes in fuel costs, currency devaluation, and the cost of purchased power.

By supporting the establishment of Private Power and Infrastructure Board (the one-stop shop for investors) and the WAPDA Private Power Organization (WPPO) to implement the 1994 IPP policy, and by giving emphasis under that policy on the use of government guarantees, it may have had the unintended effect of enabling vested interest in the sector (WAPDA and the sector ministry) to "capture and stall" the implementation of the structural changes envisaged by the Government in the 1992 Strategic Plan for the privatization of the Pakistan Power Sector, i.e. the unbundling of the WAPDA Power Wing and the introduction of competition in the market. After substantial delays, the unbundling of the power sector is almost complete (i.e. restructuring of WAPDA's power wing into about 14 corporate entities, with the remaining WAPDA responsible for hydropower generation and the National Transmission and Dispatch Company initially operating as a single buyer). The assignment of all IPP contracts to WAPDA's successor companies once restructuring was complete was foreseen in all PPAs/implementation agreements. Although the load dispatch center needed upgrading and market operating rules could be refined, the dispatch rules were well established (based on lowest variable costs) and generally respected, despite some reports of WAPDA's own plants being favored. However, the main issue was WAPDA's inability to pay the IPP capacity charges due to its weak financial position. The main effect of the delays in WAPDA's restructuring/privatization has been, however, that expected efficiency improvements, including restoring the financial health of WAPDA's successor companies failed to materialize even today and investments in upgrading the transmission and distribution system

[7] It is noted that capacity charges, which were front-loaded, have declined over time since most IPPs have been in operation for several years. Consequently, the cost per kWh generated have generally declined as well.

have not always been made. This remains an impediment to attract fresh private capital in the power sector in general and for new generating capacity in particular.

Benchmark Pricing vs. Competitive Bidding.

Rather than proceed through competitive bidding for private power, Pakistan instead set a bulk tariff ceiling for investors in an effort to accelerate the private power program and reduce transaction costs in order to quickly address the blackout situation facing the country. This was a very successful tactic in attracting foreign investors, but too many projects were approved and the selection process was not transparent. It is likely that some projects for which Letters of Support were issued, and indeed some of those which ultimately reached financial close, benefited from political support since no clear criteria existed to determine which projects to prioritize when the Government was faced with negotiating project agreements with almost 80 potential IPP developers. In addition, setting prices rather than bidding allowed for inefficiencies (e.g. projects which were too small and not least cost) and corruption opportunities on non-price issues (e.g. securing the necessary fuel supplies and WAPDA's transmission investments). In hindsight, the Government should have restricted the number of projects under the bulk tariff scheme, moved to competitive bidding and staggered solicitation over a few years so that changes in international investors' assessment of country and contract risks should have led to declining bid prices. Staggering IPP solicitation and competitive tendering would also have provided time to validate the economic and power demand growth expectations based on updated developments.

Large IPP programs need to be carefully managed.

The scale of the IPP program was perhaps ahead of its time given the country's state of development (in terms of social, economic, political, and institutional governance), and may have been better being piloted before encouraging wider use. A power system can accommodate a small IPP program without major financial dislocation. Indeed, adding IPP capacity to a slow reforming sector can be a catalyst for reform. However, project economics still matter if the government is assuming some risk and several lessons emerge from the Pakistan experience including the need to:

tailor public financial support and guarantees to facilitate an efficient investment program. Pakistan was successful in limiting Bank supported political risk guarantees to only two large projects and in providing subordinate debt under PSEDP I and II to only four large or medium size IPPs. However, all 16 IPPs received government support under Implementation Agreements whereby the government backstopped the payment obligations of state-owned power utilities and the state-owned fuel suppliers. It is doubtful whether any IPPs could have been financed in Pakistan without government guarantees since perceptions of Pakistan's risk had limited financing to terms of 18-36 months. Nevertheless, such support should have been limited only to projects of clear priority that could be afforded by the country. In addition, both private as well as public investment in generation should be consistent with an economic least cost power supply plan.

have an efficient fuel supply policy particularly the rational use of natural gas (electricity generation is usually one of the highest value uses of gas) and allow IPPs to procure fuels in competitive markets, both foreign and domestic. This also links to the concept of least cost power mentioned above. It should be noted, however, that at the time the 1994 Private Power Policy was conceived, Pakistan did not think it had a lot of domestic natural gas available for power generation.

limit the size of the first IPP to enable ready substitution if a key participant drops out and allow the Bank to take a more hands-off role in the details of the transaction. The 1,292 MW, US$1.6 billion Hub Power Project was the first IPP transaction in Pakistan and entailed a complicated financing structure.[8] The project emanated from two unsolicited offers which were subsequently consolidated and required six years to

[8] The Hub financing package included seven senior debt facilities, most of which had a syndicate of commercial banks. There were more than 70 financial institutions represented in the financing structure (including 43 international commercial banks, 9 local banks, several export credit agencies, etc.) This was in addition to the sponsor group and contractors.

reach financial close. The difficulties with the project can largely be attributed to its size. Until Pakistan had developed a track record of GOP contractual performance and successful implementation of power projects in the power sector, the Government should have concentrated its efforts on modest-sized, and as a consequence, more easily financeable projects.

create capacity to manage IPP contracts. While Pakistan created institutional capacity to approve new IPPs, and the creation of PPIB as a "one stop shop" for investors is widely credited as a key advantage in preventing bureaucratic delays, WAPDA did not put in place an effective contract management unit to manage their commercial contracts with the private sector. Furthermore, WAPDA was conflicted as the sole buyer, system operator and competing power generator which argues for unbundling, at least, transmission.

ensure efficient plant dispatch. Since fuel is the main element of WAPDA and IPP costs, the power system needs to be operated to ensure that the plant with the lowest variable operating cost is dispatched first, subject to location, transmission constraints, and that undue preference is not given to any plant, public or private. WAPDA's current dispatch facilities do not fully recognize all relevant factors.

Due Diligence by Other Lenders.

Given the overall government guarantees provided through the Implementation Agreements, it appears that private sector lenders, export credit agencies and even the IFC and the Bank primarily relied on the risk allocation framework as contained in the security package, and discounted the potential country, macroeconomic and sector risks. The parties may have also drawn undue comfort from the Bank Group's involvement in the 1994 Private Power Policy. The lesson is that the assumed future country conditions at appraisal can be substantially different from what actually emerges. When substantial changes do occur, all parties should recognize and accept that re-negotiation may happen. (See further discussion on re-negotiation below.)

Contingent Liabilities.

Under Implementation Agreements signed with IPPs, the Government guaranteed the payment obligations of the state-owned power offtaker (WAPDA or KESC) and the fuel supplier. In addition, GOP guaranteed the availability and convertibility of payments in foreign exchange. While foreign investments have many beneficial effects, they also entail at some point the repatriation of profits and the servicing of foreign debts. The capacity of a country to meet these new obligations is necessarily related to its capacity to increase foreign exchange earnings through exports. Particularly in the case of the power sector, where investments in excess of US$5 billion were made, the incremental foreign exchange outflow is on the order of US$800 million per annum, equivalent to eight percent of Pakistan's exports. The Bank did not investigate the matter until 1995 in the context of the due diligence process for the Uch partial risk guarantee. The analysis concluded that under most scenarios, Pakistan would have serious difficulties in meeting the incremental foreign exchange obligations. Furthermore, given that contingent liabilities also arise in the case of oil and gas development, Pakistan ought to put in place, possibly at the Central Bank, a monitoring system for contingent liabilities.

Bank's Role in Dealing with Corruption Allegations.

When corruption was alleged in some of the sub-projects (especially Hubco), the Bank initially found it difficult to respond given its multiple roles (i.e. advisor to the Government, lender to WAPDA, indirect lender to IPPs through the LTCF, and guarantor to commercial lenders through the partial risk guarantees). In the case of the four IPPs financed under PSEDP I and II, and in particular the Hub and Uch projects for which the Bank also provided partial risk guarantees, the Bank was a party to the private sector transaction and was looked upon by both the Government and the private sector as having a positive role to play in resolving the dispute. Standard Bank practice would dictate that the Bank not get involved in commercial disputes; however, the Bank had a responsibility to act once the partial risk guarantees were under threat of being called by the lenders as a result of what was perceived to be government events of default.

The Bank had to maintain an "honest broker" role in a situation where different parts of the Bank Group at times played conflicting roles: IFC as a lender to IPPs was trying to mitigate its reputational risk vis-a-vis its syndicated B loans; the Project Finance Group in the Bank which was focusing on mitigating calls to the Bank's partial risk guarantee; the country economic team and energy team were concerned about the macro impact and were advising the Government on the reform agenda. Furthermore, IPP sponsors applied pressure on the Bank through their Executive Directors, governments and legislators, whereas the Government applied pressure on the Bank to live up to its zero tolerance policy on corruption and requested assistance in their corruption investigation. Their argument for Bank assistance centered on the Bank's earlier, pervasive role in putting the Hubco deal together and approving the documentation, in addition to being the main advisor to the Government in developing the IPP Policy. In all, this pushed Bank staff and management to play a more proactive role than may have otherwise been the case. However, despite the varied interests of the World Bank Group in the dispute, the Bank Group's overall objective remained the development of Pakistan and this objective guided the Bank's decision making. Overall, the Bank Group was recognized as playing a positive role in the resolution of the IPP disputes.

Renegotiations.

Initially, the Bank had advised the Government to separate the commercial and criminal issues in an attempt to bring the perception of an orderly framework to resolving the IPP disputes. WAPDA was facing severe cashflow problems and was not in a position to honor its payment obligations under the PPAs. In addition, the country's foreign exchange reserves were dangerously low which jeopardized the Government's obligation under the Implementation Agreements to convert rupees into foreign exchange. Some IPPs indicated a willingness to renegotiate in recognition of the country's difficulties, but not under duress and coercive tactics. However, separating the commercial and corruption issues proved difficult to do in practice in the case of Hubco, where the Government/WAPDA was of the view that the original commercial terms were fraudulently obtained. Ultimately, both Hubco and the Government/WAPDA requested the Bank to act as a facilitator in resolving the dispute since attempts by the parties to renegotiate the commercial terms were continuously bogged down in corruption allegations and refutations. However, the Bank was not (and should not) be represented at the actual negotiating table as it is not a party to the contract. Overall, the lesson learned is that governments and governmental agencies should be encouraged to pursue corruption strictly according to law and internationally recognized due process, and in the meantime contractual obligations should be honored.

Renegotiating concession agreements is not unusual in the private sector, particularly when prevailing conditions substantially change (e.g. external macro shocks). However, negotiations will more likely result in a prompt and mutually acceptable solutions when they occur in a commercial atmosphere, free of coercion.

Lastly, in the context of future IPP solicitations, it may be useful to set out the principles of how the benefits or burdens of future debt refinancing or restructuring should be shared among the parties involved. Including such principles in future PPAs could: (a) facilitate the restructuring of debts in jeopardy situations, and/or (b) encourage IPPs to refinance debt in the event interest rates fall substantially and refinancing could lead to significantly lower cost of debt to the benefit of the both the IPPs and the host country. Not having had at the outset such "rules of the game" could be one of the reasons for the few incidents of debt refinancing or restructuring among the Pakistan IPPs.

ANNEX 1. PAKISTAN PRIVATE POWER PROJECTS

	PROJECT NAME/ LOCATION *	NOTES	TECHNOLOGY AND FUEL	CAPACITY GROSS (MW)	CAPACITY NET ** (MW)	COMMERCIAL OPERATIONS DATE
1	AES Lalpir Limited Lalpir	/a	Steam turbines on fuel oil	362	351.3*	Nov. 6, 1997
2	AES Pak Gen (Pvt) Co. Lalpir	/a	Steam turbines on fuel oil	365	343.9*	Jan 2, 1998
3	Altern Energy Limited Fatch Hang, Attock		Flared gas	14	13	Apr. 30, 2000
4	Fauji Kabirwala Power Co. Kabirwala, Dist Khanewal	/d	Combined cycle on gas	157	150*	Oct. 21, 1999
5	Gul Ahmed Energy Ltd, Korangi Town, Karachi	/a/e	Fuel oil	136.17	128.5*	Nov. 3. 1997
6	Habibullah Coastal Power Quetta		Combined cycle on natural gas	140	126*	Sep. 11, 1999
7	Japan Power Generation Off Raiwind Rd, Near Jia Baggo		Diesel engines on fuel oil	120	107	Mar. 14, 2000
8	Kohinoor Energy Limited Raiwind – Manga Road	/a	Diesel engines on fuel oil	131.44	126	Jun. 20, 1997
9	Liberty Power Project Daharki		Combined cycle on natural gas	235	211.9	Apr. 30, 2000
10	Northern Electric Co. Ltd. Choa Saidan Shah, Chakwal		Steam turbines on coal	6	5.5	Jun. 30, 2003
11	Rousch (Pakistan) Power Ltd Sidhnai Barrage Punjab	/b	Combined Cycle on fuel oil	412	355.1*	Dec.11, 1999
12	Saba Power Co. Ltd. 9 km from Sheikhupura	/d	Steam turbines on fuel oil	114	109	Dec. 31, 1999
13	Southern Electric Power Co. Raiwind, Lahore	/b	Diesel engines on fuel oil	115.2	112.1*	Jul. 12, 1999
14	Tapal Energy Limited West Karachi	/d /e	Fuel oil	126	125.5*	Jun. 20, 1997
15	Uch Power Limited Dera Murad Jamali	/a /b /c	Combined Cycle on low Btu gas	586	548*	Oct. 18, 2000
	TOTAL under 1994 Policy			**3,020**	**2,813**	
16	Hub Power Project Tehsil Hub, District Lasbela	/b /c	Steam turbines on fuel oil	1292	1200	Mar. 31, 1997
	TOTAL incl. Hub			**4,312**	**4,013**	

* Four IPPs were terminated after reaching financial close: (i) Davis Energen (Pvt) Ltd. (gas turbines on flared gas, 10.5 MW); (ii) Eshatech (Pvt) Ltd. (coal, 20 MW); (iii)Power Generation Systems (diesel engines on fuel oil, 116 MW); and (iv) Sabah Shipyard (fuel oil, 288.6 MW)

** Actual initial dependable capacity

/a IFC participation /b PSEDF participation /c IBRD Guarantee
/d MIGA participation /e PPA with KESC

Source: Private Power and Infrastructure Board

ANNEX 2. SUMMARY OF HUBCO LEGAL DISPUTES

On May 8, 1998 a *pro bono publico* constitutional petition was filed in the Lahore High Court (LHC) against the Company. The Petitioner challenged the decision of the Government and WAPDA to enter into the Power Purchase Agreement (PPA) on the grounds that the tariff was discriminatory in favor of the Company. The Petition also accuses the Government, WAPDA and the PPIB of having acted *malafide* and fixed a tariff which was unjustifiable.

At the request of the Petitioner, the LHC issued interim orders, which were subsequently amended by the Supreme Court (SC), that prohibited the Company from making distributions from reserves as of December 31, 1997 to shareholders and restricted the fixed element of the tariff to a maximum of Rupees. 845 million per month plus billing in respect of Energy Purchase Price. Although directed by the SC to dispose of the matter by the end of 1998, the petition has not been fixed for hearing so far. The petition is being contested by the Company which believes that it is without merit.

In a related action on July 9, 1998, pursuant to the PPA, the Company filed a request for arbitration in the International Court of Arbitration of the International Chamber of Commerce (ICC for hearing in London seeking a declaration that Amendment No. 2 to the PPA is valid and that WAPDA is bound by its terms. The Tribunal was fully constituted in mid-January 1999. The Tribunal first met on February 22, 1999 but could not proceed as the Company was restrained by a Pakistani court order from participating in the proceedings. Subsequent attempts to convene have also proved abortive for the same reason.

On October 11, 1998 WAPDA alleged that the Supplemental Deed dated November 16, 1993 and Amendments Nos. 1 and 2 of the PPA dated February 24, 1994 and September 17, 1994, respectively are void *ab initio* because they were said to have been procured by unlawful means. WAPDA is claiming in addition the repayment of Rupees. 16 billion allegedly overpaid. The Company has rejected the allegations made by WAPDA and has included these issues in the ICC Arbitration. The Company had issued notices to WAPDA under the PPA which could result in the termination of the PPA. Corresponding notices had also been issued in respect of the Implementation Agreement (IA) and the Fuel Supply Agreement (FSA). These notices could lead to the termination of the PPA and, as a consequence, of the IA which event would entitle the Company (and through the Company the shareholders of the Company) to compensation as set out in the IA. However, the operation of these notices were subsequently suspended by the Supreme Court of Pakistan by an order passed on an application moved by WAPDA. The operation of the notices continues to be suspended to date.

In aid of its request for arbitration, the Company filed suit in the High Court of Sindh in November 1998, requesting the Court to direct WAPDA to proceed to ICC arbitration and restrain WAPDA from taking any proceedings except ICC arbitration. In March 22, 1999 WAPDA was directed to proceed to arbitration by the Court which was appealed by WAPDA. The Appellate Court suspended the earlier order and also restrained the Company from proceeding to arbitration. Challenges by the Company were filed and hearings on that issue concluded in June 1999 and judgment was reserved.

By an order on August 11, 1999 the Court stated that it would hear the Company application with WAPDA's appeal and also continued the restraint on the Company to proceed with the ICC arbitration. The Company petitioned the Supreme Court against this order. The Company's petition was converted to an appeal on October 27, 1999 and heard by a five member bench of the Supreme Court.

On June 14, 2000 the Company's appeal was dismissed by the Supreme Court by a majority of 3 to 2 and the Company was restrained from invoking the arbitration clause of the PPA for the purpose of resolving its disputes with WAPDA through the agreed forum of ICC arbitration.

On July 10, 2000 the Company filed petition in the Supreme Court seeking a review and reversal of the majority judgment of June 14, 2000.

The above is summarized from Hub Power Company Limited *Annual Report 2000*. In December 2000, the parties agreed to a settlement whereby *inter alia* the tariff level was reduced and all criminal and civil cases were to be dismissed.

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