



POLICY BRIEF: SEQUENCE OF PRIVATIZATION IN THE ENERGY SECTOR

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Issue Background

Private investors considering purchase of energy-generating state-owned assets must have reasonable confidence in getting paid for the energy produced. As the absence of bids in the May 2005 tender to privatize Ulaanbaatar Power Plant # 2 showed, potential investors did not have sufficient confidence in the sector's current payment system to provide enough revenue for continued day-to-day operations, repayment of the excessive debt and making a return on their investment while doing so.

To avoid such future setbacks in the energy sector, the GoM should implement proper sequencing of the privatization process to meet the following requirements:

- Assure investors buying state-owned energy-generating companies that they will receive full and timely payment for the heat and electricity they produce
- Avoid issuance of costly government revenue guarantees to those investors
- Attract international investors' interest in the Mongolian energy sector.

Recommendations

1. Privatize the distribution and supply companies first as this is where the cash is being collected; in other words, "fix the cash register first." Private sector management will increase collections dramatically
2. Insure that tariffs collected are sufficient to cover costs and provide a reasonable return to the investors
3. Develop and maintain a predictable legal and regulatory environment where contracts are enforceable and sanctions are sufficient to curtail "free riders" non-payers of the service

Through work being done at the Energy Regulatory Authority (ERA) and supported by USAID/EPRC, Mongolia is making steady progress in setting up a cost-based, fair and transparent tariff structure. Slower progress is being made on a more investor-friendly legal and regulatory environment.

If the tariffs collected cover costs, there will be sufficient money in the system to pay generators what is owed them—on time and in full. If generation investors can be assured that they will be paid by the distribution/supply companies, they will not have to look to government or other sources for revenue guarantees, or will require only partial guarantees. Therefore, we recommend that those parts of the energy supply chain which collect the cash from customers be privatized first. And this also holds true for any other infrastructure delivery service, including water, waste water, etc.

Potential benefits

- After the successful privatization of heat and electricity distribution/supply companies, it will be easier to privatize generating assets, because potential investors view their prospect of being paid as significantly better. This will make them a less risky investment.
- Generating assets will be viewed as more attractive and generate higher prices
- The GoM may not have to provide any, or provide only partial payment guarantees to private-sector generators to make generating assets bankable for investors
- Since GoM revenue guarantees are viewed by the financial sector as sovereign obligations, the GoM will protect its borrowing capacity and credit rating.

References

- USAID/EPRC. "Policy Brief: "Energy Sector Privatization Plan." September 2004.
- USAID/EPRC. "Letter to SPC, Comments on Privatization Policy." 19 January 2005.
- USAID/EPRC. "Letter to Shareholders of PP2 & PP3." 28 July 2005.