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POLICY

BRIEF

Tariff and Licensing Laws in Zimbabwe: Implications for Private Sector Participation

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1. Introduction and Background

In most sub-Saharan countries, power utilities are monopolies, which have been largely sponsored by government, and international and multi-lateral organizations. The power sector reforms sweeping the continent are aimed at restructuring the sector into competitive private sector companies able to attract resources that will make it possible to accelerate the electrification of rural areas and marginalised urban areas. At the same time, it is expected that the private sector will provide a better and more efficient service.

In most countries, including Zimbabwe, information on power sector reforms and their impact on the economy is scanty. The research findings presented in this policy brief provide insights into power sector reforms that would be useful in decision-making and policy formulation and implementation. This is specifically with regard to the entry and increased participation of local private investors into the power sector. The major thrust of the study looked at issues that investors consider when entering a new industry.

Tariff setting mechanisms are a key element in the reform program. The study analysed the existing and proposed tariff setting mechanisms and how they will impact on the financial viability of locally financed power companies. The new Acts were also analysed in order to assess their adequacy in addressing the requirements of the new companies. Another issue addressed was that the new companies would in the short and medium-term, be operating in a very volatile macro-economic environment. Therefore, flexibility in price setting would be a key factor in order to cushion investors from the effects of inflation and devaluation.

Clear and transparent licensing arrangements and policy are a key lever for new companies entering into the power sector. The legal provisions that are made in the licensing policy and their ease of interpretation and application by private local investors are critical in attracting investors. The key question is whether the licensing policy and licensing arrangements would facilitate or hinder the entry of private sector investors. A critical look at the legal provisions for the privatization of the power sector enabled conclusions to be made on the attractiveness of these provisions to private investors. The analysis focused on both the existing and the new licensing arrangements and policy.

The government and the national utility cannot raise adequate financial resources to finance development projects in the power sector. It is important, therefore, to widen the resource base by encouraging and facilitating entry of local private investors. The research, therefore, focused on practical pre-requisites, which are important considerations for private investors before they make a decision to invest in the Zimbabwean power sector.

2. Key Findings

Tariff Laws and Tariff Setting Mechanisms in Zimbabwe

The provisions in the Electricity Act 1985 (amended in 1996), section 40(3)(4), allow the utility to set prices and to increase them in line with increases in input costs but approval from the ministry responsible for energy is required and the minister has the final ruling.

The legal and regulatory framework is silent on how the exact level of tariffs is to be determined by the utility. The law only spells out circumstances under which prices may be varied. There is no guidance as to how the tariff should be set so that the following objectives can be achieved:

- Full recovery of service provision costs
- Affording the utility a given return on investment
- Incentives to drive down costs and increase efficiency
- Checks and balances on monopolistic tendencies by the utility

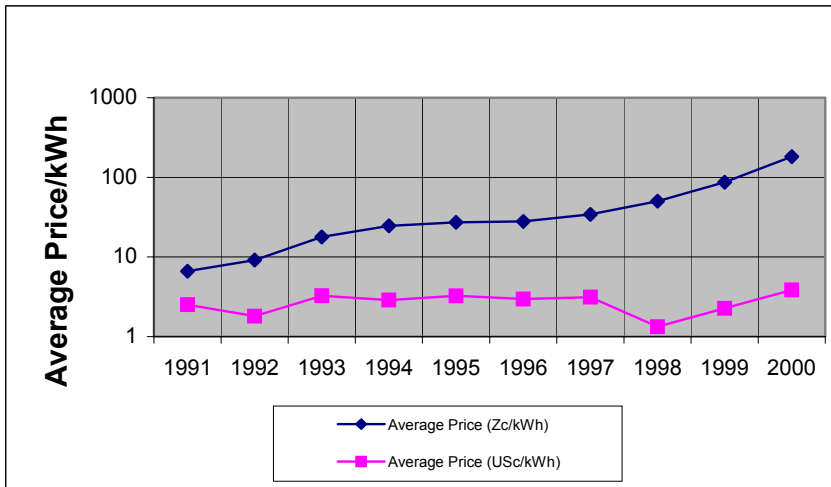
Without guiding principles enshrined in the laws, it is unclear what criteria will be used by the minister to determine an appropriate tariff. The provisions to vary the prices are meant for the utility only and not for other private players. Therefore, the existing tariff laws are meant to apply in a monopolistic and not a competitive environment. Issues like transparency and autonomy in tariff setting are not clearly spelt out in the current laws.

Parallel to the legal and regulatory framework, the utility, Zimbabwe Electricity Supply Authority (ZESA), has in place a tariff setting policy and principles, which are detailed and comprehensive. Long Run Marginal Studies (LRMC) have been instituted by the utility in accordance with government policy. They are based on the projected load forecasts and the utility's System Development Plan. Cost of Service (COS) and Customer Analysis Studies are supposed to be conducted each year to guide the pricing process. The former is meant to determine the revenue cost coverage per class. Revenue Cost Coverage Ratios (RCCs) for each class of customers are important in determining the required tariff increases. The latter is meant to make adjustments to the tariff structures so that they reflect the customer characteristics.

However, because of a number of constraints including government controls, the utility has not been able to implement fully and consistently the pricing policy and principles. The tariff is the major source of revenue for the utility, contributions from other sources such as interest receivables and miscellaneous revenue is insignificant. The level of tariff that is granted has an important bearing on profitability.

Throughout the 1990s, the level of tariffs granted to ZESA have fallen short of the LRMC level (6.32 USc/kWh on the average) and as a result it has not been possible to set aside funds for future expansion. The table 1 and figure 1 illustrates this situation.

Figure 1: Average Price



Note: The graphs have been drawn to a logarithmic scale due to the huge differences between the Zimbabwe dollar and US\$ equivalent tariffs.

Table 1: Average Tariff

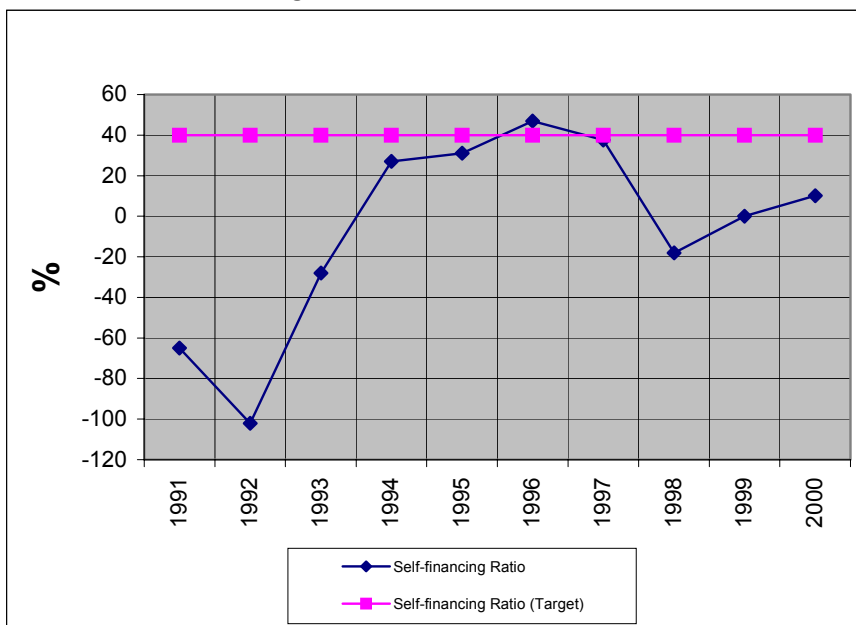
Average Tariff	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Zc/kWh	6.6	9.1	17.9	24.6	27.2	27.9	34.3	50.3	87.1	181.8
USc/kWh	2.5	1.8	3.3	2.9	3.3	3.0	3.1	1.3	2.3	3.9
Exc. Rate Z\$/US\$	2.639	5.051	5.482	8.54	8.38	9.40	10.96	18.94	38.59	47.23

Note: The unit charges in Z\$ are in nominal terms

Source: ZESA Corporate Statistics

Figure 2 shows that although the self-financing ratio has been on an upward trend, it nevertheless falls short of the target level. This highlights ZESA's inability to finance new capacity at the generation level.

Figure 2: Self-financing Ratio



Source: ZESA Corporate Statistics

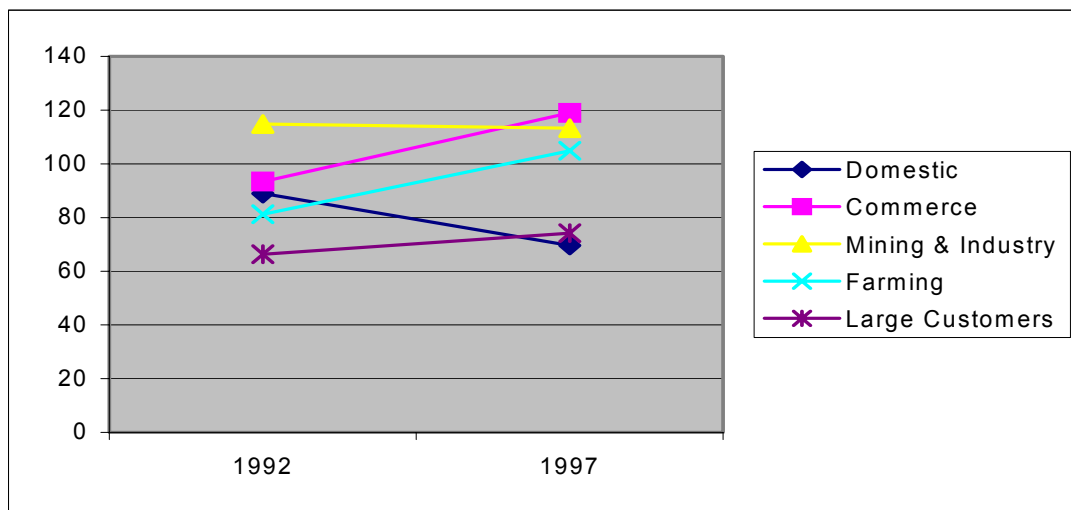
The tariff setting mechanism used by the utility requires a lot of information and it has not been possible to update the information every year to ensure that costs are accurately traced and the correct tariff is charged. Table 2 gives the revenue and cost coverage ratios for 1992 and 1997.

Table 2: Revenue Cost Coverage Ratios

Category	Domestic	Commerce	Mining & Industry	Farming	Large Customers	Average
RCC Ratio (%) 1992	88.90	93.35	114.83	81.23	66.30	92.90
RCC Ratio (%) 1997	69.57	118.98	114.25	104.84	74.22	96.95

Note: Industrial Classification Approach was used to derive ratios
Source: ZESA Corporate Statistics

Figure 3 indicates that for the domestic customers group, the Revenue Cost Coverage Ratio has been falling between 1992 and 1997, and they have been consistently below the 100% RCC mark. The graph is falling, indicating that the utility is continuing to make a loss or some other classes are subsidising the domestic category. For the commerce customer category, it is interesting to note the steep increase in the RCCs, contributing the highest level of RCCs. The contribution of mining and industry has always been above 100% RCCs. With the farming customer group, the RCC ratio has increased from 81% to 104%, showing efforts within the utility to recover the full cost coverage ratio. However, the RCCs for the large customers are low and the rate of increase in the RCC ratio is insignificant between the two years. On average the RCC ratio is high but it is still below 100% for the two years.

Figure 3: Revenue Cost Coverage Ratios

Source: ZESA Corporate Statistics

Table 3: LRM Levels between 1999 and 2000

Category	Domestic	Commerce	Mining & Industry	Farming	Large Customers	National Average
LRMC Tariffs (USc/kWh)	7.50	6.61	6.31	6.31	4.58	6.32
Dec 1999 Tariffs (USc/kWh)	1.96	3.29	2.50	2.76	1.32	2.27
Dec 2000 Tariffs (USc/kWh)	4.40	7.58	5.20	6.18	2.06	4.73

Source: ZESA Corporate Statistics

The automatic tariff adjustment formula was introduced with the objective of hedging the utility against the harsh macro-economic environment. In 1997, the tariff levels were seriously eroded by the falling Zimbabwe dollar, resulting in the low tariffs recorded in 1999. Because of the controls on pricing and a high gearing ratio, ZESA faces high-risk exposure to inflation and exchange rate movements. The automatic tariff adjustment formula has been very helpful in tracking increases in costs and factoring them into the tariff. To continue applying it effectively requires continued government willingness. It can be seen that in 2002, there were significant rises in the tariff levels for all customer groups due to the automatic tariff adjustment formula. Commerce was the only customer group being charged above LRM levels in 2000, followed by the farming sector, which had almost achieved the required LRM tariff.

The utility has devised tariff policies and principles that should provide a good basis for pricing but has not been able to implement them fully. The major factor has been the tariff approval process. Analysis of the approval process, by looking at the date applied for and the date approval was granted, reveals that delays between 1991 and 2000 range between three to four months at most with no delays having been registered in four financial years. However, in terms of financial viability, these delays are very costly. Once approved, it also takes time for the tariff to be factored into the billing system.

Other issues influence the final tariff that is charged to the customer. This includes the ability to pay by each tariff category, the ability to pass on costs and government directives. It is evident that the tariff that is finally charged does not lead to the full recovery of costs of supply from each customer group, clearly necessitating the need for cross-subsidies between customer groups.

No specific cross-subsidisation policy has been provided over the years. That responsibility has been left to ZESA, to decide how the vulnerable groups should be protected. The process has resulted in some categories such as the service industry, particularly commerce, and the productive sector being penalised because they have the ability to pass on costs.

It can be ascertained that having a good tariff policy and tariff setting principles and mechanisms is not very useful without autonomy in pricing endorsed in the accompanying legal and regulatory framework. Government has political, economic and social objectives to balance and in this regard the economic and financial objectives of the utility have taken a back seat. The government has sought to protect the load-limited consumers and domestic consumers in general from tariff increases. At the same time, the government has not advocated for a transparent subsidy policy for those classes contributing less than their full cost coverage ratios.

The new tariff laws in the new legal and regulatory framework make a significant improvement over the existing ones and are meant for a competitive environment. There is autonomy and transparency in tariff setting together with clear principles that address the needs of investors and other stakeholders. Measures have been built into the legal and regulatory framework to encourage efficiency and ensure good returns for investors. Consideration has also been given to the protection of vulnerable groups.

3. Licensing Laws in Zimbabwe

The Electricity Act (Revised 1995), gives ZESA, the mandate to generate, transmit and distribute power in the whole country. However, within the same Act (Section 33 – 36), there are provisions which cater for the entry of private players who want to 'establish, maintain or operate any undertaking' with a rated capacity of 100kW or more. The revised 1995 Electricity Act does not specifically make reference to licensing or licensing arrangements. The major findings are summarised below:

- a) In the current Legal and Regulatory Framework (LRF) in Zimbabwe there are no licensing arrangements to facilitate the entry of new players into the power sector. There is also no licensing policy to guide the entry of new players.
- b) There are provisions that have been put into the Act which provide for the approval of new investors into the power sector. The utility carries out the detailed technical and financial analysis and recommends to the Ministry responsible for energy. The Ministry gives the final approval.
- c) Experience has shown that it is difficult for investors to understand this process. Some investors have approached the Zimbabwe Investment Centre and others the Ministry. Sometimes ZESA has done all the necessary analysis and signed agreements and then asked the Ministry to ratify them.
- d) The information that has been asked for has not been consistent but has varied from project to project. Perhaps this also depends on the nature of the project proposal. The applicant only knows the types and number of documents that are required when they formally apply and a response is given. Under such an environment, it is difficult for new investors to accurately assess the attractiveness of the market before coming in as well as to accurately judge the cost of doing business.

- e) There is no clarity on part of the LRF with regard to the regulation of the new investors in the power sector. ZESA specifies the modalities for the operations of the new entrants. The Ministry may also request operational details and regular information, which allows it to monitor the operations of the new investor.
- f) The time scale between the application to establish a new business and the final approval is not stipulated. In this regard, it is difficult to assess the effectiveness of the approval system because there are no stipulated timings and dates.
- g) Tariffs for private undertakers are renewed annually in line with ZESA's tariff movements. ZESA has played a role in determining the tariff to be agreed on in a PPA. In present power contracts currently, the tariffs that have been negotiated with private developers are 80% of ZESA's annual average tariff.
- h) The Electricity Act mainly deals with the roles of the utility and the Ministry in the processing of new applications. Sometimes there is no clear-cut demarcation between what the Ministry does and what the utility does. The roles of the new investor, the customers and other stakeholders are not clearly laid out. It can be seen that the legislation is meant for a monopolistic situation where the State and the utility are custodians of public interest.
- i) To a large extent the new policy and licensing arrangements adequately cover the shortcomings in the current provisions.

4. Policy Recommendations

The findings and the conclusions reached on the tariff laws and tariff setting mechanism highlight the need for the following areas to be addressed:

- Autonomy in tariff setting is an essential component that will ensure that pricing is done based on set and clear principles. This autonomy must be enshrined in the tariff laws.
- The guiding principles for tariff setting should ensure the viability and profitability of investors while at the same time protecting customer groups from unfair practices.
- Formulation of a subsidy policy is necessary in order to recognize that there are vulnerable groups of customers, from whom service providers cannot recover the full cost of supply.
- Flexibility in tariff setting is essential in order to take into account the volatility in the macro-environment.
- To successfully recover costs and to ensure the provision of a good service, it is important that the tariff setting mechanisms automatically adjust for increases in input costs. This becomes critical in an unbundled environment where private investors have expected a good return on their investment.

Based on these conclusions, the following recommendations are being put forward:

- a) Autonomy in tariff setting should be enshrined in the tariff laws.
- b) The guiding principles for tariff setting should encourage efficiency, ensure the viability and profitability of investors while at the same time protecting customer groups from unfair practices.
- c) An electricity subsidy policy should be formulated with clear criteria for the identification of recipients and the delivery modes in order to facilitate the entry of private sector players.

The findings and the conclusions reached on whether a clear licensing policy and transparent and efficient licensing arrangements will attract investment, highlight the need for the following areas to be addressed:

- The current provisions and arrangements for the approval of new investors should be phased out and replaced with the proposed new provisions in order to facilitate the entry of private sector players.
- The current provisions and arrangements are meant for a closed power sector where the utility has monopoly and actually regulates the entry of other players.
- The policy and licensing arrangements are not clear and transparent and as a result the number of private players who have entered the power sector has not been significant.

Based on these observations, the following recommendations put forward:

- a) The current provisions and arrangements for the approval of new investors should be phased out and replaced with the new provisions
- b) The new provisions and arrangements for the approval and entry of new investors into the power sector should be harmonized and build into a one-stop-shop to facilitate the entry of private sector players.

5. Conclusion

The research was carried out to prove or disapprove whether existing and proposed tariff laws in Zimbabwe encourage the participation of private sector players in the power sector. The findings have revealed and highlighted the shortcomings in the existing legal and regulatory framework, in terms of their inability to reflect actual costs and to contribute to the profitability of the utility. The proposed laws are a significant improvement from the current ones and their implementation would contribute to meeting the requirements of private sector investors.

The second component of the study analysed whether a clear licensing policy, and transparent and efficient licensing arrangements, will attract investment. In the existing legislation the specificity and separation of policy making, regulatory functions and management/ownership functions with regard to the licensing policy and licensing arrangements is not clearly defined. The new laws, however, to a large extent address the shortcomings of the current legislation and it is hoped they will be enacted into law soon so that a conducive environment for the attraction of private sector investors is created.