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978-0-521-86502-9 - The Political Economy of Power Sector Reform: The Experiences of Five Major Developing Countries

Edited by David G. Victor and Thomas C. Heller

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The Political Economy of Power Sector Reform

Over the last fifteen years the world's largest developing countries have initiated market reform in their electric power sectors from generation to distribution. This book evaluates the experiences of five of those countries – Brazil, China, India, Mexico and South Africa – as they have shifted from state-dominated systems to schemes allowing for a larger private sector role. As well as having the largest power systems in their regions and among the most rapidly rising consumption of electricity in the world, these countries are the locus of massive financial investment and the effects of their power systems are increasingly felt in world fuel markets. This accessible volume explains the origins of these reform efforts and offers a theory as to why-despite diverse backgrounds-reform efforts in all five countries have stalled in similar ways. The authors also offer practical advice to improve reform policies.

DAVID VICTOR is Professor of Law at Stanford Law School and Director of the Program on Energy and Sustainable Development at Stanford University.

THOMAS C. HELLER is Lewis Talbot and Nadine Hearn Shelton Professor of International Legal Studies at Stanford University.

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Notes on contributors

DAVID VICTOR is Professor of Law at Stanford Law School and Director of the Program on Energy and Sustainable Development at Stanford University. The Program, launched in September 2001, focuses on reform of electric power markets, the geopolitical consequences of newly emerging global natural gas markets, energy services for the world's poor, and managing climate change and other environmental consequences of modern energy systems. Much of the Program's research concentrates in Brazil, China, India, Mexico and South Africa. He teaches energy law and regulation at Stanford Law School.

Previously, Dr. Victor directed the Science and Technology program at the Council on Foreign Relations in New York, where he remains Adjunct Senior Fellow and Director of the Council's task force on energy. At the Council his research focused on the sources of technological innovation and the impact of innovation on economic growth. His research also examined global forest policy, global warming, and genetic engineering of food crops. His Ph.D. is from the Massachusetts Institute of Technology (Political Science and International Relations), his B.A. from Harvard University (History and Science).

THOMAS HELLER is coordinator of the Rule of Law Program at CDDRL, a CESP senior fellow, and the Lewis Talbot and Nadine Hearn Shelton Professor of International Legal Studies at Stanford. His work focuses on international law and political economy, law and development, energy law and policy, and environmental law.

Heller has been on the Stanford faculty since 1979 and has served as associate dean of the Law School (1997-2000), deputy director of FSI (1989-1992), and director of the Overseas Studies Program (1985-1992). He was a member of the faculty at the University of Wisconsin from 1971 to 1979, and served as co-director of the Center for Public Representation in Madison, Wisconsin, during 1976-77. He

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has been a visiting professor at several institutions, including Hong Kong University (2003), the European University Institute (1992-93 and 1996-99), the Catholic University of Louvain (1998), and the Center for Law and Economics at the University of Miami (1977-78).

He was previously a fellow of the Humanities Research Institute at UC-Irvine (1989), a Kellogg National Fellow (1981-83), and a fellow of the International Legal Center at Bogota, Colombia (1968-70). He received an AB from Princeton University in 1965 and an LLB (law degree) from Yale University in 1968.

VÍCTOR G. CARREÓN-RODRÍGUEZ is chair of Department of Economics at the Centro de Investigación y Docencia Economicas (CIDE). He has been a professor of economics at CIDE since 1998.

ADILSON DE OLIVEIRA is a professor of economics at the Institute of Economics at the Federal University of Rio de Janeiro. He is a member of the editorial board of *Utilities Policy*, has consulted for several Brazilian energy companies, and has advised the Brazilian Ministry of Energy on power industry reform. Prof. de Oliveira holds a Ph.D. in development economics from Grenoble University in France and a specialization degree in energy economics from the Institut Economique et Juridique de l'Energie.

ANTON EBERHARD is professor at the university at the Cape Towns school of Business. He teaches executive courses in the management of reform and regulation of infrastructure industries in Africa. For seven years, he was a Board Member of the National Electricity Regulator of South Africa. He founded and directed the Energy and Development Research Centre at the University of Cape Town between 1989 and 1999, is a foundation member of the Academy of Science of South Africa, and serves on numerous councils and boards including the Western Cape Regional Electricity Distributor. He is also an editorial board member of the *International Journal of Economic Regulation and Governance*.

ARMANDO JIMÉNEZ SAN VICENTE was Director of Energy Policy of the Secretary of Energy in Mexico. Dr. Jimenez received his Ph.D. from the London School of Economics (LSE) in 2002 where he worked on the political economy of tax collection in Mexico and the constraints on reform.

JUAN ROSELLÓN is currently the Repsol-YPF-Harvard Kennedy School Fellow at Harvard University, and a tenured professor of the Department of Economics at the Centro de Investigación y Docencia

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Economicas (CIDE). He has also held faculty positions at the Program on Privatization, Regulatory Reform and Corporate Governance at Harvard University (1997–2000) and at Princeton University (2001).

RAHUL TONGIA is a research faculty member at Carnegie Mellon University in Pittsburgh, PA. His research interests include energy, power, networking and telecom infrastructure development in developing countries. He holds a Bachelor's degree in electrical engineering from Brown University and Ph.D. from the Department of Engineering & Public Policy at Carnegie Mellon University.

CHI R. ZHANG is the current Cambridge Energy Research Associates, Inc. (CERA) Director of China Energy. His research focuses on China's evolving electric power and natural gas markets. Prior to joining CERA he was head of China research for the Program on Energy and Sustainable Development at Stanford University. Dr. Zhang holds a Ph.D. in economics from Johns Hopkins University and has worked at the Institute for International Economics in Washington, DC, the Monterey Institute of International Studies and the Institute of World Economics and Politics at the Chinese Academy of Social Sciences in Beijing, China.

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Preface

Over the last fifteen years the world's largest developing countries have initiated market reforms in their electric power sectors. This book evaluates the experiences in five of those countries – Brazil, China, India, Mexico, and South Africa. These five are important in their own right, as they have the largest power systems in their regions and their consumption of electricity is among the most rapidly rising in the world. They are the locus of massive financial investment – from domestic and foreign sources, both public and private – and the effects of these power systems are increasingly felt in world fuel markets. In addition to their intrinsic importance, these countries reveal important variations in reform efforts. Their power systems have been organized in distinct ways, have different primary fuels and technologies, and have been reformed under quite different strategies.

In the pages that follow, we explain the origins of these reform efforts and proffer a theory as to why – despite diverse backgrounds – reform efforts in all five countries have stalled in similar ways. We also suggest that our theory may have more general application to electricity reform beyond these five countries and also to reforms of other network industries.

In the broadest sense, this book advances four arguments. First, we suggest that these five countries initiated reform efforts at approximately the same time not simply because “markets” were a fad or that market-oriented elites controlled key governments and multilateral institutions such as the World Bank. Rather, a series of investment crises created political opportunities that reformers exploited in their push for markets. And while every country story varies, some elements are common across the five case studies. In most countries, electricity had become politicized and thus tariffs for politically favored groups were set at levels that did not cover costs. At the same time, many of the economies of scale that led to ever-declining costs faced technological exhaustion. The state enterprises that ran the power system got squeezed between inadequate revenues and rising costs, and state budgets were increasingly unable to cover the difference – especially for governments

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that were also struggling to manage the consequences of the 1980s debt crises. With a country in financial crisis it was easier to make the politically difficult choices that are intrinsic to power market reform – for example, raising tariffs and privatizing state enterprises.

Second, we show that all these countries articulated their reform strategies with reference to a “textbook” model of power sector reform – one written largely on the basis of the successful reforms in England and Wales. In practice, each country followed its own strategy in pursuit of that textbook outcome. Some started reform efforts with distribution companies; others focused on generation and transmission. Some sought large-scale privatization of the power sector, while others focused their attempts on attracting private enterprise in special niches as “independent power producers (IPPs)” that sell electricity to the grid under state-backed long-term contracts.

These varied reform strategies have not had much impact on the actual functioning of the power sector. Much more important than reforms in the power sector have been reforms in other parts of the economy – notably in state budgeting and capital markets. Wherever states have imposed hard budget constraints and where firms face real opportunity costs of capital the electric power sector has generally become more economically efficient, regardless of the particular reform strategy that the government has pursued. Other complementary reforms have also played important roles. For example, the progress with judicial reform helps to explain why some regulators have been able to issue meaningful orders while others find their dicta ignored by firms and enterprises that know the courts will not back the regulatory authority.

Third, each study has examined the effects of power sector reform on the various elements of the “social contract” that has long existed between society and state-dominated electric power systems. This contract includes varied investments in public purposes, such as the supply of low-cost electricity to poor households, as well as public goods such as protection of the environment and investment in innovation. Many analysts have feared that power sector reform would undermine that contract because profit-oriented firms would focus on their bottom line rather than these broader public services. We find little support for that fear because reformers, in practice, have generally adopted a wide array of complementary policies such as special subsidy programs and tax incentives that have sustained (or even expanded) investment in social services.

Fourth, we argue that early in the reform process a special class of firms and enterprises emerges to play a dominant role in reform. These

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organizations, which we call “dual firms” are marked by their strong interest in *avoiding* full-blown reform, for they thrive in the murky middle ground between the old state-dominated system and a fully open and competitive private marketplace. Dual firms, we argue, are distinctive because they are governed to perform two tasks simultaneously. On the one hand, they are able to mobilize the political connections needed to get plants financed, sited, and dispatched and to obtain the subsidies and payment guarantees that are necessary for profitable infrastructure investments. Simultaneously on the other hand, these firms are efficiently managed so that the resources they obtain are not squandered through poor operations and bloated payrolls. Performing both these tasks is exceptionally difficult; some of the organizations that do it have arisen originally through state ownership (e.g., China’s Huaneng Power, Brazil’s Petrobras, South Africa’s Eskom, and India’s National Thermal Power Corporation); others trace their origins to private enterprise (e.g., India’s Reliance and Tata companies). Power sector reform has differed from the textbook model not simply because it is technically difficult to create private markets. Rather, power reforms have stalled because these dual firms know that they thrive best in the partially reformed world and have the ability to prevent full-blown restructuring of the sector.

We thank the many collaborators and reviewers who have participated over the nearly three years of this study. We launched the effort at Stanford with a February 2003 meeting on the experiences with power sector reform, at which the authors presented early drafts of their studies. Thanks to the chairmen, speakers, and discussants at that meeting for their focused critique of our methods and results: Ralph Bailey, Don Baker, David Bodde, Jim Bushnell, Ralph Cavanagh, Robert Crow, Craven Crowell, Zhou Dadi, Alberto Diaz, Shyam Divan, Alex Farrell, Charles Feinstein, Leo Feler, T.J. Glauthier, David Holloway, Arvind Jadhav, Stephen Krasner, Ron Lillejord, Hugh McDermott, Granger Morgan, Alberto Pani, Dionisio Perez-Jacome, Jayant Sathaye, P.R. Shukla, Jonathan Sinton, Bernard Tenenbaum, Jim Williams, Mason Willrich, Frank Wolak, and Kurt Yeager. We and our collaborators are grateful to the many follow-up meetings with officials in government and industry as well as academics.

In parallel with this study, the Program on Energy and Sustainable Development (PESD) participated in two studies on related topics. One focused on independent power projects (IPPs) was ably led by PESD’s Erik Woodhouse. As the present study will show, IPPs are typically the primary vehicle for attracting private capital for investment in new infrastructure, and thus a retrospective on the IPP experience is an

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essential complement to the full examination of power sector reform that is presented in this book. In addition to Erik, we are grateful to the many other scholars who participated in the IPP study: Felipe Araujo, Efe Cakarel, Katia O. Karpova, Joshua House, Peter Lamb, Luciano Losekann, Alejandra Nuñez-Luna, Adilson de Oliveira, Jeff Rector, and Pei Yee Woo. PESD also collaborated with Anton Eberhard and Katharine Gratwick at the University of Cape Town who studied the IPP experience in Africa. The IPP study, although funded mainly by PESD, benefited from a seed grant from the Bechtel Initiative on Global Conflict and Cooperation through the Freeman-Spogli Institute for International Studies; we thank John Weyant and Bob Crow for their efforts to initiate the work on IPPs with the Bechtel funding.

Second, in parallel with this study PESD also collaborated with Prof. P.R. Shukla at the Indian Institute of Management (Ahmedabad) to examine the effects of power sector reform on technology choices in two Indian states. We thank the U.S. Agency for International Development for funding that study and for the continued support of the USAID team in Delhi: Richard Edwards, John Smith-Sreen, Sandeep Tandon, and Glenn Whaley. We are especially grateful to our collaborators Debashish Biswas, Tirthankar Nag, and Ameer Yajnik. That study on two Indian states mirrored an earlier study, funded by the Electric Power Research Institute, that examined the effects of power sector reforms on electric technologies in three Chinese provinces, and we thank our colleague Michael May who co-led that effort and contributed in many ways to the present study.

Finally, and most importantly, we thank our collaborators and PESD's main funders. Our collaborators have been notably patient with our lengthy review and extensive editorial process. We have been blessed with generous and consistent programmatic support from the Electric Power Research Institute and BP, plc. We also thank the staff at PESD including Rose Kontak for overseeing and implementing the final stages in this undertaking – she has managed the production process and also played an instrumental role in the final rounds of editing. Others at PESD have also been exceptionally helpful, notably Becca Elias and Bob Sherman; we are also grateful to Josh House who helped oversee the project in its earlier stages. Our editors at Cambridge University Press, Chris Harrison and Lynn Dunlop, were a pleasure to work with throughout the publication process.

David G. Victor and Thomas C. Heller
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