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Are we ready for subsidy reform?

Govt needs to provide details for rakyat over rationalisation in energy sector

By DR FONG CHAN ONN

THREE days ago, Energy, Green Technology and Water Minister Maximus Ongkili hinted at an imminent electricity tariff hike.

Granted, our current tariff is low by world benchmarks; granted, too, that this has resulted in distortions to the economy and our loss of competitiveness.

However, the rakyat will be more comforted if the Government can provide details on the reforms it plans to carry out in the energy sector, especially in getting rid of past inefficiencies, to justify the price hike.

In January this year, the International Monetary Fund (IMF) published a study in which energy subsidies and their reforms in over 176 countries were evaluated.

It found that subsidies are particularly acute in oil-exporting countries, which accounted for two-thirds of the total fuel subsidies of the US$480bil (RM1.5 trillion) (0.7% of total world GDP).

The IMF study outlines six crucial steps towards a successful energy sector reform. They include:

> a comprehensive energy sector plan with clear long-term objectives;

> transparency in the magnitude of the subsidies;

> price adjustments in stages;

> efficiency and accountability in the state power producers;

> targeted measures to protect the lower income groups; and

> depoliticising energy pricing via a market-based mechanism or automatic pricing mechanism.

My short stint as the Sustainable Energy Development Authority (SEDA) chairman has exposed me to some of the reforms carried out in the Malaysian energy sector. These are important steps towards liberalising the energy sector.

However, there are gaps which I would like to highlight so the poor and lower income groups are not burdened by the more transparent automatic pricing mechanism that is being put forward for deliberation.

The IPP baggage

In the Malaysian context, there is an added issue of Independent Power Producers (IPPs) whose decades-long controversy continues to haunt the Government and have become the convenient whipping boy for the Opposition to stir public sentiment.

The three key controversies surrounding the IPPs are:

a) the lack of transparency in the negotiations in the 1st generation IPPs back in the 1990s;

b) the "take or pay" deals enjoyed by the IPPs; and

c) IPPs are given subsidies when the people are expected to bear the burden of subsidy rationalisation.

First of all, the power sector is now subjected to a clear set of rules of engagement under the Incentive-based Regulation (IBR) that was introduced by the Suruhanjaya Tenaga (ST) in 2011.

Under the competitive bidding process, all power generators including Tenaga Nasional Berhad (TNB) must bid for the lowest price before they are given the licence to build a plant.

The idea is to introduce competition into the generation sector that has long been said to be "inefficient".

Secondly, the "take or pay" deal was only given to YTL Power because the risks that it undertook at that time were thought to be phenomenally high. Of course, hindsight tells us that this was the wrong assumption.

However, YTL's licence will expire in 2015. Because its plant is still good, YTL is expected to bid again under the competitive bidding system so any negotiations that take place will be transparent.

As ST is the regulator, the deal will be conducted in an arms-length manner, unlike the 1990s when it was the Economic Planning Unit (EPU) which decided.

Thirdly, it must be explained that IPPs are not given subsidies. The lower prices of pipeline gas supplied by Petronas to TNB and IPPs are meant to benefit the rakyat in the form of low tariff rates.

IPPs or TNB cannot sell or trade the subsidised fuel. It can only be used to generate electricity. The simple analogy is that an IPP/TNB is much like a car – where the car (the power plant, in this case) isn't subsidised but there is a discount on the fuel so the cost of transport becomes cheaper for the consumer.

My next question: is Malaysia ready for fuel subsidy rationalisation?

Fuel subsidies were first introduced to promote political, economic and social goals but, over the long-term, many countries have found them too costly to sustain. They create market distortions and encourage wasteful consumption.

In the case of energy-exporting countries such as Nigeria, high consumption subsidies in fact erode availability and hamper foreign currency earnings.

In Malaysia, Petronas has to forgo revenues that could be better channelled to further exploration or develop high-value downstream activities. Fuel mix for Malaysia is mainly gas, and gas is an expensive premium fuel, better used for high value-added industries like glass making or ceramics. It is like using "champagne fuel" just to produce steam to power turbines.

Members of G-20 and APEC have pledged in 2009/2010 to rationalise fuel subsidies over the medium term. Some countries (like Turkey) have bitten the bullet and reformed their energy sector. But many others, particularly those in the Middle East and North Africa where fuel subsidies are hefty, have delayed reforms due to political-social unrest.

Has Malaysia taken serious steps in the six elements of subsidy reforms for the country to be competitive enough to be part of the Asean power grid? How will the poor be protected? And how can consumers help during this transition period?

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In need of transparent tariff system

In this respect, I feel we should convert our present grey system of electricity tariff adjustment to one which is transparent. It should be based on clearly specified market conditions and pre-set improvements in the delivery system.

The introduction of the Cost Efficient Tariff (CET)

The CET is one such transparent pricing mechanism. It comprises:

i) A cost element subjected to global fuel costs. This makes up about 60-70% of tariff and can be reviewed every six months.

ii) An "efficiency" element in which the power producers are subjected to a set of reward/penalty Key Performance Indicators (KPIs) monitored by the ST. This portion of the tariff can be reviewed every three years. Failure to meet the KPIs by the IPPs and TNB will result in refusal in tariff increase by the regulator ST. This portion also covers the transmission and distribution part of the power sector value chain where events like system disruptions and response time are tracked against TNB's performance (*see chart*).

How is it different from our tariffs now?

Tariff reviews now are subject to application by TNB to the Government. The appeals by TNB to review its rates are based on a general cost recovery system where the cost structure is not transparent.

We are unsure which portion is due to fuel costs and which portion is due to the cost of the plant or even due to the producer's inefficiencies. Thus, as a pre-condition to the introduction of the new tariff structure, TNB must commit itself to transparency in its value chain (generation, transmission and distribution) expenditures.

Further, it also has to commit itself to rapid improvements in areas where it is so plainly weak, such as electricity supply in Sabah, particularly in Sandakan and Tawau.

Like any other economic reforms, I believe the pain will be greater for the lower income groups. I would suggest there must be specific direct measures to help the poor. They are:

> The free electricity lifeline band should be increased from 91kWh/month to at least 300-400 kWh/month. This means more households will benefit from free electricity.

> The tariff bands should be reduced to two or three tiers only as the current six-tier band is complicated and confusing. The advantage of having clarity in bills helps promote transparency.

> Instead of using subsidies which distort markets and have leakages, the establishment of a stabilisation fund can help cushion spikes in fuel prices so price volatility in times of fuel crises can be moderated. Hong Kong and Australia have used this approach in anticipation of such situations.

> The IMF study has found that direct cash transfer to the poor for energy consumption (as done in Indonesia) is the best form of targeted subsidy. This could be in the form of BR1M-like payments to the vulnerable groups.

> There must also be ample discussion with the SMEs whose profit margins could easily be diminished if tariffs are not announced ahead of planning/budgeting. This is particularly hard on small businesses that now have to bear the initial cost of the GST and adjustments to the minimum wage.

> The Government must conduct more aggressive public education on energy savings and energy efficiency.

> The Government must also take the lead to reduce its energy bills by having austerity programmes. In Budget 2014, the Prime Minister announced that every ministry building will now implement energy efficiency plans in its efforts to reduce wasteful consumption. This is a good start.

In summary, I feel the Malaysian energy sector's transformation over the last four to five years has covered some of the bases mentioned in the IMF study. The power sector is now a lot more prepared to take on the new challenges of a competitive environment, where consumers are more discerning in the way we price public goods and services.

They are looking for reliability, quality and sustainability of service.

If we can achieve the long-term goals of bringing our tariffs to more competitive market levels, we can join the Asean grid. We will then not need such a high margin of reserves to maintain our electricity supply security. Malaysian consumers can ultimately gain by still having more moderate tariffs compared to our neighbours.

> Dr Fong is a former professor of Applied Economics and Dean of Faculty of Economics and Administration, Universiti Malaya, and former Human Resources Minister. He aspires, unrealistically, to be a single-handicap golfer.

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