

7 Detecting Corruption Risk with Independent Power Producers

Even in countries where the electricity sector is predominantly publicly operated, the private sector may supply generation capacity through “Power Purchase Agreements”. Under this scenario, a publicly owned electricity utility contracts with a private firm to provide an agreed amount of generation capacity. Private firms providing generation capacity under these arrangements are referred to as independent power producers (IPPs).¹⁵

The sections below discuss corruption risks in IPP procurement, and some indicators sector practitioners can use to detect corruption in IPP arrangements.

7.1 Corruption Risks in Independent Power Producer Awards

Procurement of IPP contracts often involves different organizations, procedures and dynamics from the procurement of generation construction contracts. Thus corruption risks in relation to IPP contracts may differ from the risks in procuring and implementing a capital project (discussed in the previous section).

Awarding an electricity supply contract to an IPP is an alternative to the utility building its own generation capacity. In principle, as a private sector firm is responsible for the designing, constructing, and operating the generation plant, we might expect IPP contracts to provide generation capacity at a lower cost than the public utility would be able to.

It is often the case that increased private sector involvement reduces corruption and increases efficiency. However, IPP awards have been a major avenue for corruption and other governance failures in the electricity sectors in a number of countries.¹⁶ For example Karekezi and Kimani state that in Africa:

The advent of independent power producers (IPPs) has also generated controversy with major allegations of corruption and collusion between Government officials and private sector companies involved in IPP projects. IPP associated controversies have been particularly acute in Kenya, Tanzania, Uganda and Zimbabwe¹⁷

Box 7.1 summarizes some of the problems with an IPP in Tanzania.

¹⁵ For a further description of IPPs, and how they work, please see: Besant-Jones, J. (2006) “Reforming power markets in developing countries: What have we learned?” Energy and Mining Sector Board Discussion Paper No. 19, Washington, DC: The World Bank

¹⁶ This discussion focuses on privately owned IPPs, not government owned IPPs (as in Vietnam).

¹⁷ Karekezi, S and Kimani, J (2002) “Status of power sector reform in Africa: Impact on the poor” *Energy Policy* 30, 923-945. IPP contracts have given rise to allegations of corruption in a number of other countries, such as India, Indonesia, and the Philippines (see Box 7.2).

Box 7.1: Cost of Poor Investment Decisions and Less than Transparent Procurement

The Government of Tanzania and the Tanzania Electricity Supply Company entered into contractual agreements with Independent Power Tanzania Limited (IPTL) of Malaysia for the supply of 100 megawatts of power over a 20-year period. This transaction, directly negotiated during a power crisis, was contested by some government officials and by the international donor community and other interested stakeholders, on the grounds that it was the wrong technology (heavy fuel oil instead of indigenous gas), that it was not part of the least-cost generation plan, that it was not procured on a transparent and competitive basis, and that the power was not needed. The government ultimately submitted the case to arbitration. Under the final arbitral ruling, the project costs were reduced by about 18 percent. Even so, the costs remain well above international comparators. In the arbitration hearings the Government alleged that the contract award had been corrupt, but failed to produce evidence to satisfy the Tribunal of this. The government has not subsequently pursued the corruption investigation. However, legal disputes between the IPTL and the government continue.

Source: Juliet Pumpuni, World Bank Institute Global Programs, cited in Gulati, Mohinder and M.Y. Rao. "Corruption in the Electricity Sector: A Pervasive Scourge" in *The Many Faces of Corruption* and Castalia experience

IPP contracts can become an avenue of corruption for a number of reasons:

- IPPs are high value projects. IPPs usually combine the value of a contract to construct a power plant with a fuel contract over the economic life of the plant, plus other operating costs. The resulting contract values are large. Such large contracts can attract aggressive private sector interest, and thus provide substantial opportunities for public officials to misappropriate some of the value
- IPPs can be flexible. Governments often introduce them as a response to crisis situations. As the previous section discussed, crisis responses are a common mechanism for corruption. In a crisis public officials can justify deviating from existing least-cost investment plans, and from normal procurement rules. This creates an opportunity for corruption
- IPPs are still quite new. International experience in this area is still developing. As a result there is little clear guidance for sector officials as to correct procurement methods for IPP contracts
- Partly due to the lack of clear guidance on appropriate procurement processes, IPP contracts may be concluded as a commercial negotiation, without public scrutiny (and the deterrent to corruption that such scrutiny provides)¹⁸
- IPP procurement often occurs at a higher political level than other power sector procurement (such as procurement of a construction contract for a power station) and this may change the dynamics of the transaction. In particular, this may provide additional protection for corrupt behavior in some cases.

Box 7.2 discusses examples of questionable practices in IPP procurement.

¹⁸ Besant-Jones, John "Reforming power markets in developing countries: What have we learned?", Energy and Mining Sector Board Discussion Paper Paper No. 19, World Bank, September 2006, page 18

Box 7.2: Review of Questionable Practices in Independent Power Producer Procurement

Many IPP contracts are arranged through a memorandum of understanding with the electricity generators rather than through a transparent and open competitive bidding process. Governments and state-owned utilities sometimes advance the most specious reasons for failing to engage in competitive bidding, holding, for example, that the procedure has no relevance where a private sector investor chooses to set up a project using its own resources; that it would be counterproductive to insist on competitive bidding when the foreign consortium involved is composed of internationally reputed companies; that competitive bids require costly and time-consuming preparatory work; and that the expert knowledge and experience required for evaluating bids as well as for identifying and allocating risks is not available. It is also true that the wide variety of fuels and the rapidly changing technologies available for electricity generation make the decision-making process difficult for many developing countries that may not have the expertise to assess the full implications of a plant using a particular fuel or technology.

Large contracts, signed with IPPs in an environment of weak watchdog institutions, offer attractive opportunities to influential decision makers for making illegal gains. The negotiations are held in secret, and minutes are not kept at all or are very sketchy. The costs to the country and the illegal gains for those entering into the contracts are enormous. The following examples illustrate the size of the amounts involved:

- A PPA was negotiated for an Enron project (Dabhol Power Company) in the state of Maharashtra, India. After the agreement drew widespread protests and litigation, it was renegotiated by the successor government, which was headed by a different political party that was highly critical of the original PPA (Energy Review Committee 2001). During litigation over the project, the High Court of the state of Maharashtra observed that the state committee involved in the renegotiation “forgot all about competitive bidding and transparency.” The annual cost of this project to the state was computed at Rs60 billion (US\$1.3 billion). A settlement was reached among Indian financial institutions, offshore lenders, and foreign investors, and claims of foreign investors settled. The plant was taken over by a consortium of government-owned companies, but it continues to remain idle because of the high cost of generation
- In Indonesia, most IPPs seemingly provided the family and friends of politicians with “loan-financed” shares in the company. The loans were to be repaid with dividends from the shares, but the shares were essentially gifts, camouflaged to escape anticorruption laws.⁽¹⁾

Often, government uses a crisis situation to justify contracting for excess capacity or taking on more risk in terms of technology, fuel, financing terms, or capacity payments:

- The Philippines signed 42 IPP contracts between 1990 and 1994, much in excess of demand. The contracts resulted in financial burdens for the utility and the government, which had to make payments for unused capacity
- The Gujarat Electricity Board in India was forced to continue making capacity payments for naphtha-fired private generators even after increasing naphtha prices rendered these plants uneconomical.

The above examples could reflect risky or bad decisions arising from a lack of capacity in the governments and their agencies to negotiate complex contracts. However, lack of transparency, the governments’ frequent unwillingness to use competent advisers to help in negotiations, and the failure to disseminate information to the public do little to undermine allegations of corruption.

Notes: (1) Bayliss and Hall Bayliss, Kate, and David Hall. 2000. "Independent Power Producers: A Review of the Issues." Public Services International Research Unit, University of Greenwich, United Kingdom (November).

Source: Gulati, Mohinder and M.Y. Rao. "Corruption in the Electricity Sector: A Pervasive Scourge" in *The Many Faces of Corruption*

7.2 Detecting Corruption in Independent Power Producer Awards

Sector practitioners can look at the following indicators to assess the risk of corruption in IPPs:

- Unit costs
- Procurement processes
- Tender documents that mandate particular fuel or technology choices
- Energy conversion contracts.

7.2.1 Unit costs

Unit costs are probably the best indicator of corruption in IPP awards. The measure to look at is the all-in-cost of power from the generation project, compared to other projects with similar fuel supply and load factors.

7.2.2 Procurement process

The quality of the procurement process is another good indicator of corruption in IPP awards. A poor process could simply indicate a lack of capacity or inexperience with this type of arrangement, or could be a deliberate strategy to create corruption opportunities. Section 6.2.1 describes a number of indicators of corruption in procurement processes. Also refer to Section 10.2 for a description of good practice in project procurement.

7.2.3 Tender documents that mandate particular fuel or technology choices

Tender documents for an IPP award may specify the particular fuel or generation technology required. This can be a way for public officials to direct the IPP award to a preferred supplier (see Section 6.2.1).

However, some care is needed here. In many cases specificity on plant design may be appropriate. Public utilities should implement IPPs in line with an existing least cost expansion plan (see Section 6.2). Where this is the case, the existing plan will already have identified the most efficient technical option for the block of generation capacity in question. The IPP contract may simply be a way of expediting, and improving the efficiency of, a plant that a public-sector least cost expansion plan indicated should be built.

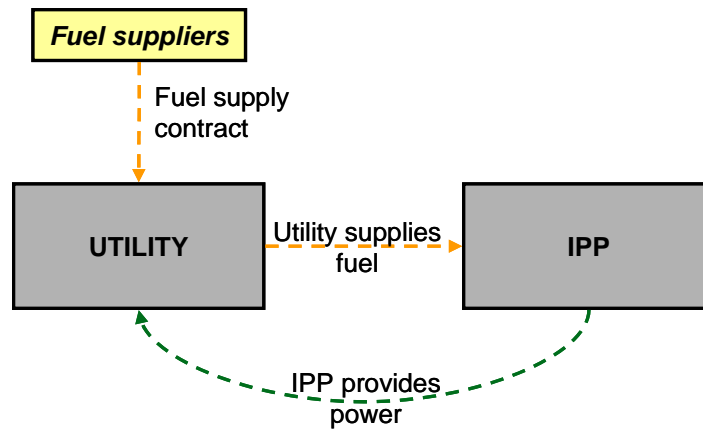
Clearly, where the public utility does not have an investment plan, tender documents that favor particular fuels or technologies may indicate corruption.

7.2.4 Energy conversion contracts

Energy conversion contracts are similar to power purchase agreements. In this form of contract the fuel contract element is separated out—the public utility agrees to supply fuel to a private firm. The firm “converts” the fuel into electricity, which it then sells back to the public utility (see Figure 7.1).

While energy conversion contracts are sometimes genuinely justified for other reasons, they can be a way to retain corruption opportunities in fuel supply in the public sector. As Section 5.1 discussed, fuel procurement can be a highly lucrative corruption opportunity for public utility officials. Under a power purchase agreement, these officials would lose the benefit of kickbacks on fuel procurement—instead the corruption opportunity would be diverted to the Minister in charge of awarding the power purchase agreement. Thus utility officials have incentives to lobby for an energy conversion agreement instead.

Figure 7.1: Simple Illustration of an Energy Conversion Contract



The table below provides a list of sources that discuss experience with IPP awards, and the potential for corruption in this area.

Source List 7.1: Sources on Corruption in Independent Power Producer Awards

Source	Description
Besant-Jones, J. (2006) <i>“Reforming power markets in developing countries: What have we learned?”</i> Energy and Mining Sector Board Discussion Paper No. 19, Washington, DC: The World Bank	This report provides a comprehensive review of the experience of electricity sector reform in developing countries. In particular, Section 4 discusses governance issues in the electricity sector, and among other things highlights corruption arising from weak governance arrangements as one of the drivers of reform in some countries.

Source	Description
<p>The Energy Group (not dated) <i>Best Practices Guide: Implementing Power Sector Reform</i>”, United States Agency for International Development</p>	<p>Chapter 2 of this <i>Best Practices Guide: Implementing Power Sector Reform</i> concentrates on independent power production and competitive bidding. It outlines the goals for IPP programs, the risks and rewards associated with IPPs, what a power purchase agreement should look like, and how the competitive bidding process should work.³³</p>
<p>Gulati, M. and Rao M.Y. (2007) <i>Corruption in the Electricity Sector: A Pervasive Scourge</i>” in <i>The Many Faces of Corruption</i>, Washington, DC: The World Bank</p>	<p>This chapter of <i>The Many Faces of Corruption</i> focuses on corruption in the electricity sector. It discusses corruption in power purchase agreements stating that “Contracts with IPPs ... are very complex. Such contracts quickly become the domain of a few experts; dissemination of relevant information and its use by the public become difficult, creating new opportunities of grand corruption by the decision maker”. The chapter signals potential sources of corruption (such as IPPs inflating supply prices for utilities, non-competitive bidding process, and illegal gains on large IPPs by influential decision makers). It provides examples of corruption in IPPs from India, Indonesia, and the Philippines.³⁴</p>
<p>Karekezi, S. and Kimani, J. (2002) “Status of power sector reform in Africa: Impact on the poor” <i>Energy Policy</i> 30, 923–945</p>	<p>This paper focuses on eastern and southern Africa, and analyzes the challenges and prospects of ongoing and planned power sector reforms (with a special emphasis on the implications for the poor). It concludes that the major challenges are poor performance at the transmission and distribution end, lack of electrification of the poor, and limited local private sector participation.</p>
<p>Sharma et al (2004) “Electricity reform in the Philippines” <i>Energy Policy</i> 32, pp. 1487–1497</p>	<p>This paper provides a case study of electricity reforms in the Philippines.</p>
<p>Woodhouse, E. (2005) <i>The IPP Experience in the Philippines, Program on Energy and Sustainable Development</i>, Stanford University, Working Paper No 37</p>	<p>An example from the Philippines of how a power crisis facilitated corruption, leading to eventual overbuilding. In this case, the government passed a law enabling it to fast track the negotiation of IPP contracts.</p>