REPUBLIC OF LEBANON

MINISTRY OF FINANCE

ELECTRICITE DU LIBAN:

A FISCAL PERSPECTIVE

(AN OVERVIEW FOR 2001 - 2009)

- March 2010 -

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I. Introduction

This report aims at depicting the fiscal perspective of Electricité du Liban (EDL), in terms of the Government transfers made to the loss-making company. In fact, Government spending on EDL constitutes the third largest expenditure item after interest payments and personnel cost. As this report acts as a one-time publication, and thus will not be produced on a regular basis, it:

1. Provides a historical overview of transfers that spans over nine years
2. Presents the analytical background behind recorded figures
3. Focuses on the record-high transfers of the past couple of years

The report starts with an overview highlighting the main challenges facing Lebanon's electricity sector and electricity company, while highlighting the latter's financial deficit. It further emphasises the need for reform measures, that otherwise would undoubtedly inflict a higher burden on budgetary resources, as well as an opportunity cost that limits the Government's ability to attend to other principal issues.

Section two provides an explanation of the components that make up the expenditure item "Transfers to EDL", shedding light on the particularity of repayment of gas oil and fuel oil bills, given the lagged repayment agreements.

The third section presents a historical overview of Transfers to EDL, looking at the past nine years – starting in 2001, which is when Transfers to EDL started to be listed in the Ministry of Finance's publications as a separate expenditure item. Particular focus is given to analysis at the oil price and consumption levels in 2008 and 2009, where yearly transfers peaked to exceed US$ 1.5 billion.

Section four explores the change in EDL's contribution to the repayment of fuel and gas oil bills. It is noted that the said contribution has become less substantial over the past few years, paralleling the utility's continuing financial problems.

The report is concluded by two sections dedicated to further presenting the sizeable burden posed by EDL, through examining the share of Transfers out of primary expenditures and out of GDP.

II. Background

Electricité du Liban (EDL) is a public institution founded in 1964 and mandated the responsibility of generation, transmission and distribution of electrical energy in Lebanon. Bill-collection also falls under the utility's responsibilities.

The electricity sector has long suffered from multi-fold issues, including low generation capacity, reliance on costly imported fuel, as well as technical and non-technical losses. The end result is the prevailing poor service quality, denoted by unreliable flow of electricity, rationing, low consumer confidence, inadequate cost-recovery, high system losses and, fiscally, substantial claim on budgetary resources.

EDL's outstanding structural deficit is rooted in that collected revenues are far from being able to cover the rising expenditures, a fact that is derived from the utility's yearly budgets shared with the Ministry of Finance. These documents also show that even if oil expenditures are excluded, the utility's financial situation remains critical. Given the mismatch between its inlays and outlays, EDL relies considerably on Government transfers, aimed primarily at covering the resulting deficit – rather than investment activities – through contributing to the repayment of fuel oil and gas oil bills. It is worth mentioning that the Government's financial support to the electricity company is by no means a recent development, where transfers date back to the civil war – although back then the frequency and structure of transfers was not systematic, as is currently the case.

In this context, unless a solid and comprehensive reform strategy is drawn and serious measures are taken shortly, Government transfers to EDL are bound to rise – thus exerting considerable pressure on the fiscal situation. Meanwhile, short-run saving opportunities arise from undertaking both spending-rationalisation and revenue-enhancement measures. The implementation of a reform strategy would eventually allow revising the current tariff structure to better reflect the cost and quality of service provision.

Going back to Government transfers to EDL, an interesting way to look at their size would be from a per capita perspective.

- In 2008, transfers reached LL 2,430 billion (US$ 1.6 billion), which translates roughly to US$ 400 per person per year.
- In 2009, and given the relatively lower oil prices, transfers reached LL 2,259 billion (US$ 1.5 billion), i.e. around US$ 375 per person per year.

III.Transfers to EDL

Government transfers to EDL cater for the following two components, where the second component pertaining to reimbursement of oil suppliers presently makes up the bulk of Government transfers to EDL, reaching 94 percent in both 2009 and 2008.

- Debt service payments include principal and interest in relation to debt contracted mainly for investment purposes, whether directly by EDL (and guaranteed by the Government) or by the Government (for the benefit of EDL). Hence, debt service in this context pertains to repayment of EDL loans, rather than Government loans contracted to cover EDL's deficit.

- Payments against fuel oil and gas oil purchases: since the end of 2005, these have been made in accordance with bilateral contracts between the Ministry of Energy and Water on one hand, and Algeria's Sonatrach (for both gas oil and fuel oil) and Kuwait Petroleum Corporation (KPC – for gas oil) on the other. These purchases are guaranteed by the Government.

As per the arrangements with Sonatrach and KPC, payments for gas oil and fuel oil purchases are made six and nine months respectively after the quantities are received. In accordance to the contracts with the said two oil suppliers, a "letter of credit" basis is followed, where suppliers provide invoices upon delivery of shipments and accordingly the stated sum[1] is blocked by Banque du Liban, awaiting future payment on the due date. It is worth mentioning that the total sum is blocked at the time of purchase from the accounts of EDL and the Treasury respectively. More precisely, funds are first sought from EDL accounts and the remaining difference is then blocked from the Treasury.

Box 1: Quantities Consumed vs. Quantities Paid

Given the lagged terms of payment (six months for Sonatrach and nine months for KPC), it is important to differentiate between the following two different, yet connected, concepts.

Quantities Consumed

Oil quantities consumed in a certain year are paid for either during the same year or during the following year, depending on the date of purchase.

- For KPC, shipments arriving in QI are paid for during the same year, while the remaining three quarters' shipments are paid for during the following year.
- As for Sonatrach, consumption registered during HI is paid for during the same year, while the second half's consumption is due during the following year.

Quantities Paid

"Reimbursement of KPC and Sonatrach Agreements" stands for the settlement of gas oil and fuel oil bills during a certain year. The paid sum pertains to consumption made during the same year, as well as the previous year, depending on the date of purchase.

- For KPC, payments made during a certain year reflect consumption registered during the last three quarters of the previous year, as well as the first quarter of the year under consideration.
- As for Sonatrach, payments made during a certain year reflect consumption registered during the second half of the previous year, as well as the first half of the year under consideration.

[1] The total sum as listed in the invoice covers four main components: (i) principal: to cover the cost of delivered fuel/gas oil, (ii) interest: incurred given the lagged payment agreements, (iii) demurrage: to compensate for delays in unloading the shipments and (iv) premium: to cover freight and insurance costs.

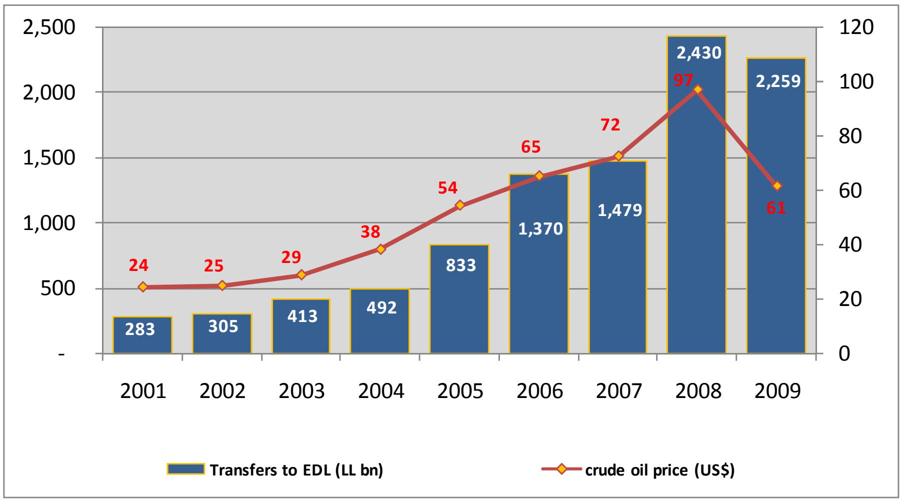
IV. Historical Overview of Transfers to EDL

Prior to 2005, transfers to EDL were recorded as treasury expenditures, based on decrees issued by the Council of Ministers. Starting 2005, transfers to EDL were included in the yearly budget as an allocation classified as a loan. In 2009, the said budget classification was amended to become a subsidy to the electricity company.

In terms of figures, transfers to EDL witnessed an eight-fold increase over the past nine years, reaching LL 283 billion in 2001 and rising to LL 2,259 billion in 2009, after registering a peak of LL 2,430 billion in 2008, as shown in the chart below.

The rise in transfers over the years is the result of higher international oil prices, coupled with growing demand for oil. Figure 1 illustrates the positive correlation between oil prices and transfers to EDL during the period 2001 - 2009.

Figure 1: Transfers to EDL and international oil prices (2001-2009)



Analysis in the following sections will focus on the years 2008 and 2009, due the noticeable surge witnessed in transfers in these two years, to exceed US$ 1.5 billion.

IV.1 Analysis for the peak year 2008

At LL 2,430 billion, 2008 transfers increased by 64 percent over the 2007 level. This notable rise caters for considerably-high fuel oil and gas oil payments, as follows.

- Price effect in 2008

  Oil prices witnessed a global surge in 2008, to reach a yearly average of US$ 97 per barrel – up from US$ 72 per barrel in 2007[2]. In fact, within 2008, July registered the highest price of US$ 133 per barrel.

[2] In fact, the average annual international oil price and the registered yearly oil consumption are not what the transfers precisely reflect, due to the lagged terms of payments to the two oil suppliers. However, as the data series under consideration spans over nine years, the lagged effect is normalised, the general oil price-transfers correlation is maintained and the upward consumption trend is carried on.

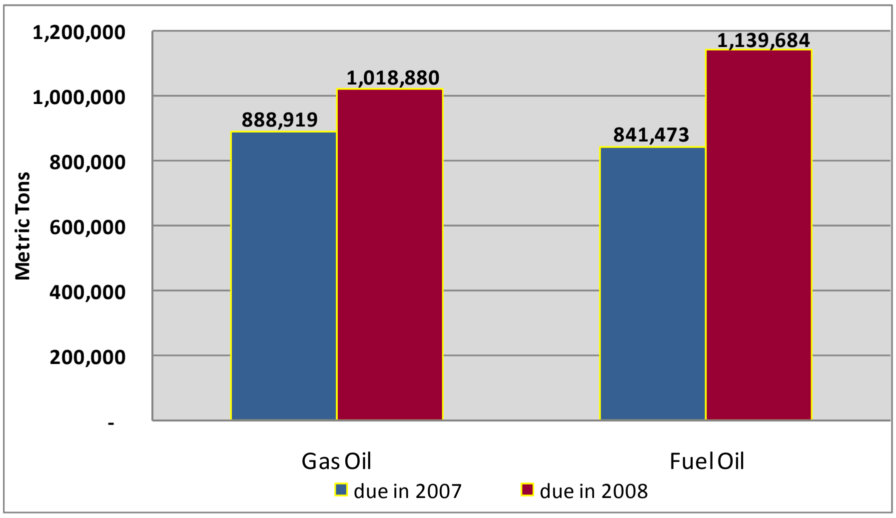
➢ Quantity effect in 2008[3]

Gas oil and fuel oil quantities, for which the 2008 payments to the oil suppliers were made, registered notable increases as shown in Figure 2 below. In fact, the former rose by 21 percent over its 2007 level to reach 1,018 thousand tons; and the latter grew to a larger extent by 35 percent, to register 1,139 thousand tons.

These quantities represent *paid quantities*, rather than *consumed quantities* (kindly refer to Box 1 for more details about the distinction between the two concepts) during 2008, as it is the latter that impact the yearly transfers to EDL.

The information available to the Ministry of Finance is confined to oil invoices, which do not allow drawing substantial explanations behind the rise in quantities.

Figure 2: Gas oil and fuel oil paid for in 2007 and 2008



IV.2 Analysis for the year 2009[4]

The same two-level analysis can be applied to 2009, where Government transfers to EDL registered a decrease of 7 percent from its 2008 level to reach LL 2,259 billion. In fact, the drop came mainly as a result of the decrease in payments to Kuwait Petroleum Corporation (KPC) and Algeria's Sonatrach for fuel and gas oil purchases by LL 144 billion, as per Table 1 below.

[3] The quantities presented in this analysis are those for which the yearly payments are made, amount of fuel oil and gas oil *consumed* during the year, due to the lagged terms of payment to KPC and Sonatrach. It should be mentioned that this does not affect the overall trend, where the same inferences regarding rising demand can be made when taking the quantities consumed into consideration.

[4] For more details on Transfers to EDL in 2009, kindly refer to the monthly publication entitled “EDL-Monthly Snapshot” for December 2009. The publication provides a monthly overview of the third largest public expenditure item, through exposition of the monthly fiscal transfer to EDL and the analytical reasons behind its fluctuations.

Table 1: Government transfers to EDL 2006-2009*

(LL billion)	2006	2007	2008	2009	Change 09/08	% Change 09/08
EDL, *of which:*	**1,370**	**1,479**	**2,430**	**2,259**	**-172**	**-7.1%**
Debt Service, *of which:*	**249**	**365**	**155**	**127**	**-28**	**-18.1%**
• C-Loans and Eurobonds, *of which:*	228	272	115	93	-22	-18.9%
- *Principal Repayments*	*181*	*235*	*94*	*79*	*-15*	*-15.7%*
- *Interest Payments*	*47*	*37*	*22*	*15*	*-7*	*-32.6%*
• BDL-Guaranteed Loan Payments	5	92	40	34	-6	-15.8%
• Other	17	-	-	-	-	-
Repayments of oil suppliers arrears	**217**	**-**	**-**	**-**	**-**	**-**
Reimbursement of KPC & Sonatrach	**903**	**1,114**	**2,275**	**2,131**	**-144**	**-6.3%**

Source: Ministry of Finance

** This table does not cover years prior to 2006, as payments to oil suppliers were not made according to a "letter of credit" arrangement, and thus the component "Reimbursement of KPC & Sonatrach" cannot be compared as such.*

The 6 percent drop in "Reimbursement of KPC and Sonatrach Agreements" to reach LL 2,131 billion in 2009 is explained by the following two factors combined:

- the overall average oil price according to which the 2009 payments were made is lower than that pertaining to 2008 payments
- the overall gas oil *quantities paid* in 2009 was higher (26 percent), coupled with slightly lower fuel oil quantities (1 percent)

Box 2: Gas Oil Consumed in 2009 in comparison with 2008

Consumed quantities of gas oil registered the following levels (whether the payments of which are due in the same or following year) – based on letters of credit opened during the year:

- 2009 1,118 thousand tons
- 2008 1,219 thousand tons
- 2007 885 thousand tons
- 2006 1,094 thousand tons

Comparing 2009 to 2008, the resulting variation of around 100 thousand tons kicked in the last two months of 2009, where no change was registered in gas oil consumption during the first ten months of 2009 as compared to the same period of 2008 (both at around 1 million tons). It is worth noting that as the decline was recorded in November and December of 2009, the downward quantity-derived impact on payments to the oil suppliers will materialise in 2010. In fact, natural gas arrived from Egypt to the Deir Amar plant in North Lebanon in late October 2009, thus explaining the lower level of demand for gas oil during the last two months of the year. A contract was signed in May 2009 between Lebanon and Egypt for the supply of natural gas, where the pipeline passes through Jordan and Syria before reaching Lebanon.

The provision of natural gas represents a major step within combustibles diversification, and is among the key sector reforms aimed at reducing the production cost of energy. It should be kept in mind that as natural gas comes to replace the costly gas oil, the impact is on the cost rather than on supply of electricity.

V. Contribution of EDL to the Total Oil Bill

Government transfers to EDL are made to support the latter cover its oil bill. As EDL's operating losses exacerbated its deficit, Government contribution to repaying fuel oil and gas oil suppliers has become more substantial over the past few years.

As shown in Table 2, EDL's contribution out of the total paid oil bill in the past four years dropped from a high of 19 percent in 2006 to a low of 5 percent in 2008. In 2009, and with a total due oil bill of LL 2,333 billion and Government payment reaching LL 2,131 billion, EDL contributed by 8.3 percent to the component "Reimbursement of KPC and Sonatrach Agreements". The Ministry of Finance does not have an official explanation behind the variation in EDL's contribution.

Table 2: Breakdown of Total Oil Bill 2006 – 2009*

(LL billion)	2006	2007	2008	2009
Total Oil Bill, *of which paid by*	**1,111**	**1,280**	**2,409**	**2,333**
• *EDL*	18.7%	13.0%	4.7%	8.3%
• *Government*	81.3%	87.1%	94.4%	91.4%
• *Other (refineries)*	0.0%	0.0%	0.8%	0.3%

Source: Ministry of Finance
** Breakdown not available prior to 2006*

Box 3: Variation in EDL's contribution to the oil bill in relation to the utility's collected electricity bills

One interesting way to look at the variation in EDL's contribution to the overall oil bill is to examine the utility's collected electricity bills, where a certain relationship between the two can be roughly inferred.

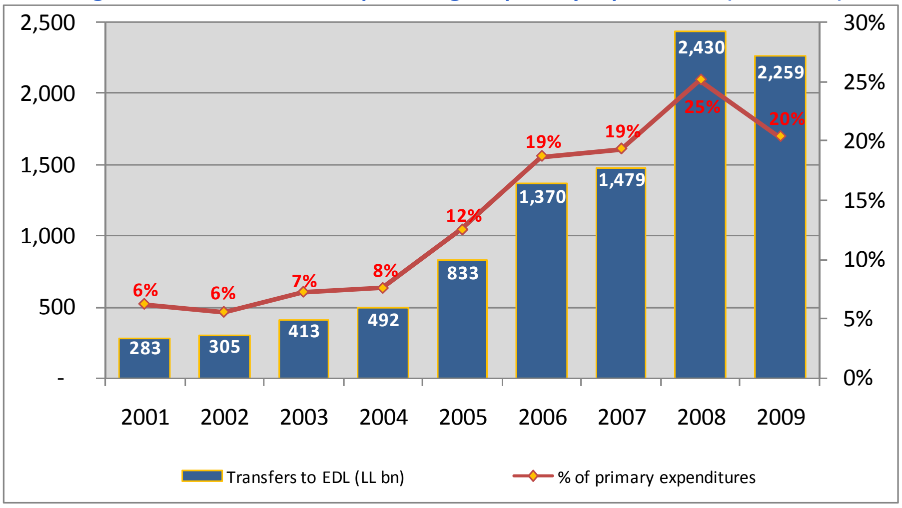
For example, EDL's contribution to the oil bill in 2008 was low compared to 2007. At the same time, the total oil bill in 2008 was almost double that of 2007 (with rising international oil prices and growing demand for oil), while collected electricity bills registered a level that was the same as 2007.

In 2009, EDL's contribution improved to some extent to reach 8.3 percent of the total oil bill. At the same time, the oil bill was around 3 percent smaller than that of 2008, while bills collected by EDL were about 10 percent higher than the 2008 level.

VI. Transfers to EDL out of expenditures

Transfers to EDL out of primary expenditures maintained an upward trend over the years, starting at 6 percent in 2001. The share gradually rose to record 19 percent of primary expenditures in 2006 and 2007. A peak of 25 percent was witnessed in 2008, as the extent of the rise in Transfers was much higher than that in primary spending, mainly as a result of the surge in international oil prices. In 2009, and with the relative decline in oil prices coupled with a continued rise in primary expenditures, the share of spending on EDL went down to one-fifth, as shown in Figure 3 below.

Figure 3: Transfers to EDL as percentage of primary expenditures (2001-2009)

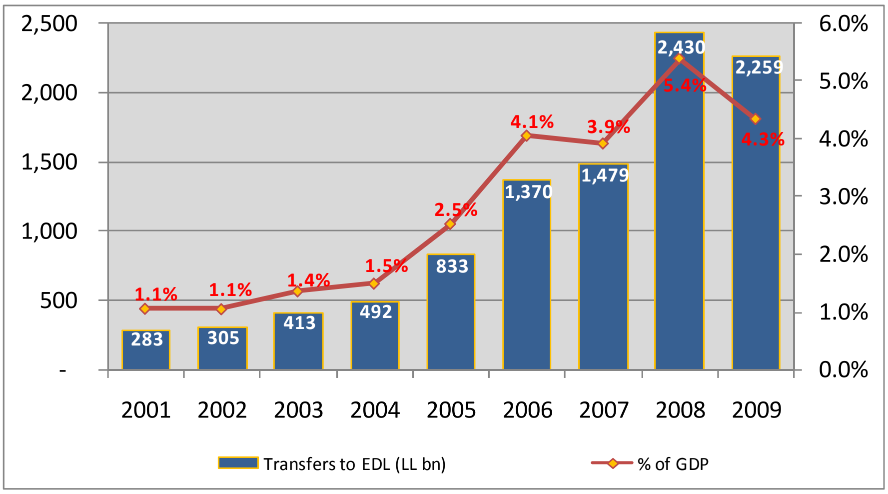


It is worth mentioning that when taking total expenditures into account, transfers to EDL are the third largest public expenditure item, after interest payments and personnel cost.

VII. Transfers to EDL in percent of GDP

EDL has constituted a sizeable burden on the Lebanese economy, a fact that can be detected from several perspectives, including percent of GDP. In fact, Transfers in percent of GDP witnessed a notable rise over the years, starting at 1 percent in 2001. The figure gradually rose to record 4 percent of GDP in 2006 and 2007, followed by a peak of more than 5 percent in 2008 due to the fact that Transfers rose at a higher rate than GDP. As Government transfers to EDL slightly declined to reach LL 2,259 billion in 2009, and with GDP expected to grow by about 15 percent, the share is expected to decline to 4.3 percent, as shown in Figure 4 below.

Figure 4: Transfers to EDL as percentage of GDP (2001-2009)



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