II Issues and Perspectives

The State budgets for 2011-12 reflected a fiscal stance generally consistent with the fiscal roadmap laid down by the Thirteenth Finance Commission. Although a majority of States have revised their FRBM Acts, most of them do not include provisions for additional disclosures for enabling transparent assessment of their finances. The recommended restructuring of public expenditure system envisages doing away with plan-non plan distinction of budgetary expenditures for not only improving the efficiency of expenditure management but also for attaining desirable outcomes. There is also a need to rationalise the operation of Centrally Sponsored Schemes to address the issues of lack of flexibility in these schemes, counterpart funding shortage from the States and low utility of large number of schemes with thinly spread resources at the field level. Financial losses of State Power Utilities continue to be a drag on the finances of States, which necessitates not only renegotiation of debt liabilities of distribution utilities but also undertaking necessary reforms for enabling independent functioning of State Electricity Regulatory Commissions and addressing issues relating to tariff revisions. The State finances should also capture both explicit and implicit liabilities associated with certain off-budget activities including project financing undertaken through SPVs/public-private partnership mode. There is also a need for greater focus on structural issues which pose significant fiscal challenges, particularly for those States which could not undertake rule-based fiscal corrections prior to the crisis years of 2008-09 and 2009-10.

1. Introduction

2.1 As the second phase of rule-based fiscal consolidation has commenced for the States from 2011-12, the underlying emphasis should not only be on reverting to a sustainable fiscal path but also in drawing lessons from the past and developing new perspectives to address the key challenges. In particular, while the incentivised approach towards fiscal correction should continue, there is a need to address the structural rigidities, especially for the States which had missed out in the first phase of implementation of rule-based fiscal discipline. Greater fiscal transparency is also critical for monitoring the quality, durability and effectiveness of fiscal correction at the State level. The efficiency of expenditure management systems for the public sector as a whole needs to be improved for achieving desired outcomes. From the perspective of fiscal stability, deterioration in the financial conditions of State Power Utilities (SPUs) may require a reassessment of the potential impact on State finances. With increasing recourse to public-private partnerships mode for project financing, State governments need to recognise both explicit and implicit contingent liabilities in this regard. Against the backdrop of an uncertain global economic environment, prudent management of interest rate and exchange rate risks associated with external loans (on back-to-back basis) poses a new challenge. This chapter raises key questions about the fiscal challenges faced by the States and attempts to provide an assessment on each of them.

2. Fiscal Consolidation

How does the budgetary stance of States for 2011-12 compare with the revised road map of fiscal consolidation of the Thirteenth Finance Commission? Are there some structural issues which still hamper rule-based fiscal correction for the few States that missed it earlier?

2.2 The incentivised fiscal consolidation process followed by the State governments under the legislative framework of Fiscal Responsibility and Budget Management (FRBM) prior to the global crisis, had enabled most of them to not only attain surpluses in their revenue account but also achieve impressive reductions in their fiscal deficits. With the disruption in the fiscal consolidation process due to the exceptional circumstances of 2008-09 and 2009-10, the States needed to resume their fiscal consolidation process at the earliest. In this context, the Thirteenth Finance Commission (ThFC) had envisaged that the States would be able to revert to their fiscal consolidation path by 2011-12, allowing for a year of adjustment in 2010-11.

2.3 According to the revised roadmap chalked out by the ThFC for the States, all non-special category States that had attained balance/surplus in their revenue account in 2007-08 were to return to revenue balance by 2011-12 and maintain it thereafter. These States were also expected to achieve a fiscal deficit of 3 per cent of GSDP by 2011-12. The State budgets of 2011-12 show that barring two States (Goa and Haryana), all other non-special category States, which had attained revenue balance in 2007-08, have either budgeted for balance or surplus in their revenue accounts for 2011-12. The GFD-GSDP ratio was budgeted to be within the stipulated 3 per cent for all these States except Goa and Jharkhand.

2.4 The ThFC had recommended a separate adjustment path for three States (Kerala, Punjab and West Bengal) which had revenue deficits in 2007-08, so as to eliminate the same by 2014-15.[2] While the budgeted revenue deficit to GSDP (RD-GSDP) ratio for 2011-12 is higher than the ThFC target in the case of Kerala, it is lower than the target for Punjab. West Bengal's budgeted RD-GSDP ratio for 2011-12 is in line with the ThFC target. While the budgeted GFD-GDP ratios for Kerala and West Bengal for 2011-12 are within their respective ThFC targets, the budgeted GFD-GDP ratio for Punjab was marginally higher than the target.

2.5 Non-attainment of the revenue account targets by Kerala and Punjab precluded these States from being granted debt relief (which is linked to progressive reduction in their revenue deficit) from 2008-09, although they continued to get interest relief from the Centre. As West Bengal had not enacted its fiscal responsibility legislation at the time, it was not entitled to avail the benefit under the debt waiver scheme, thereby losing out on both debt relief as well as interest relief from the Centre. The basic problem of the finances of West Bengal lay in its own tax revenue (OTR)-GSDP ratio which was substantially lower than that of other States. Apart from not being able to fully reap its revenue potential (with inadequate stamp and registration duty collections even during real estate boom phases), the low mobilisation of OTR reflected a lower tax base or per capita income and lower potential for certain tax collections, particularly in respect of motor vehicles, whose number stood lower than that of other States like Andhra Pradesh with a comparable population size. Consequently, growth in West Bengal government's revenues could not match its expenditure growth. In the case of Kerala, pensions and salaries continue to be one of the main drivers of revenue expenditure. Pension expenditure is also high in the State for two reasons *viz.,* (a) the lower stipulated age of retirement than the other States (b) the non-introduction of the new pension scheme (NPS). While the State has constituted a cabinet sub-committee to examine the issue of raising the retirement age of its employees on par with the other States, no decision has yet been taken on the NPS. In the case of Punjab, although its own tax and non-tax revenues in terms of GSDP compare well with the respective national averages, the revenue expenditure-GSDP ratio is higher than the national average. The average share of development expenditure in total expenditure is significantly lower than the national average as the State is weighed down by high committed expenditure. In terms of interest payments-revenue receipts ratio, Punjab

[2] Of these three States, Kerala and Punjab had enacted their FRBMs in 2003 and West Bengal did so only in 2010. Under their FRBM Acts/ Rules, Kerala and Punjab were to achieve revenue balance by 2006-07.

ranks the second highest in the country. Concerted efforts are being taken by the three States to improve their fiscal positions and their progress is being monitored by the Central government.

2.6 To address the problem of interest rate asymmetry between the Centre and the States with regard to loans to the States from the National Small Savings Fund (NSSF), the ThFC had recommended that the interest rate of NSSF loans contracted by the States till 2006-07 and outstanding at the end of 2009-10 be reset at a common interest rate of 9 per cent in place of the existing 10.5 per cent/9.5 per cent. A State will be considered eligible for this interest relief from the date of amendment/enactment of FRBM in accordance with the recommendation of the ThFC. The Union Budget for 2012-13 proposed that from 2012-13 onwards, the States will be eligible for provisional relief, based on compliance with the fiscal targets in their respective FRBM Acts, as reflected in their Budget Estimates. If a State, after getting the interest relief, breaches the FRBM in Actuals (as per Finance Accounts), the benefit of reduced interest on NSSF loans will be withdrawn and the earlier interest rate will become applicable. This excess interest relief availed by the State shall be recovered in the next year. The State may revert to 9 per cent interest rate as and when it complies with its FRBM targets again.

3. Fiscal Transparency

What disclosure and dissemination requirements in State Budgets do amended FRBM Acts entail?

2.7 The ThFC had stipulated that States amend/enact their FRBM Acts, incorporating the targets set by it as a pre-condition for the release of all State-specific grants and debt relief measures. So far, 27 States have amended their FRBM Acts/Rules setting out annual deficit and debt ceilings in terms of GSDP in accordance with the path set out by the ThFC. As the GSDP series has been revised after the release of the ThFC report, the series used by the ThFC to arrive at its targeted ratios are not comparable with the deficit/debt to GSDP ratios worked out on the basis of the new GSDP series. There is, therefore, a need to develop an appropriate measure that is consistent with the ThFC recommendation to monitor adherence to the FRBM targets.

2.8 While amending their FRBM Acts/Rules, most States have confined themselves to the minimum requirement of specifying annual deficit/debt limits as stipulated by the ThFC. The ThFC had also recommended that all States incorporate the setting up of an independent review/monitoring mechanism in their FRBM Acts. It had also suggested that States should attempt to incorporate statements on revenue consequences of capital expenditure, public-private partnerships (PPP) and related liabilities, physical and financial assets and vacant public land and buildings. Only two States (Karnataka & Arunachal Pradesh) have included these disclosures within the ambit of their amended FRBM Acts/Rules. Other States could follow this example and increase their disclosures to enhance fiscal transparency. In this context, it is also important that the States provide information on special purpose vehicles (SPVs) floated by them with a view to enhancing fiscal transparency.

4. Classification of Expenditure

What is the rationale to do away with the Plan and non-Plan distinction for classifying budgetary expenditures?

2.9 The distinction between Plan and non-Plan expenditure has, over the years, rendered the entire budgeting exercise complex and made outcome-based budgeting difficult. The classification of revenue expenditure and capital expenditure also requires a fresh look in the post-FRBM scenario in view of the need for substantial resource transfers to States and local bodies. The transfer of Central resources to States through various types of schemes and multiple modes of transfer have posed problems in obtaining a comprehensive overview of transfers to the States as well as in effective monitoring of expenditure. There are also issues concerning the accountability of funds directly transferred to implementing agencies in the States. The Eleventh Plan document also referred to innovative methods of financing projects such as PPPs and new administrative mechanisms of implementation. In this context, the scope of the public sector plan needs to be clarified. To address these issues, the Planning Commission set up a High Level Expert Committee to suggest measures for the efficient management of public expenditures (Box II.1).

2.10 The Committee's recommendation to do away with Plan-non Plan distinction in budgetary classification of expenditures envisages not only efficient management of full expenditure which envelopes various functions/sectors/services but also helps in proper linking of outlays to outcomes. This would enable transparent assessment of both costs and outcomes achieved under various categories of expenditure. Successful migration to the new system would, however, entail that the new classificatory expenditure structure gets assimilated across the government machineries at all levels including the roles to be played by the Ministry of Finance, the Planning Commission, administrative ministries and the State governments. Since the present system of plan-non plan classification plays an important role in determining grants-in-aid to the States recommended by the Finance Commission (FC), merging the plan and non-plan categories of expenditure would also require a change in assessment mechanism of the FC.

5. Central Transfers to States

How can the efficacy of Centrally Sponsored Schemes be improved?

2.11 States are primarily responsible for major sectors such as health, education and employment which often involve large public expenditures. Recognising the higher resource requirements of the States relative to their resource-raising capacity, the Constitution mandates statutory transfers of tax and grants from the Central government to the State governments in accordance with the Finance Commission awards. In addition, States also have access to central Plan funds through centrally sponsored schemes (CSS) and central assistance to State Plans. The CSSs are operationalised by Central ministries based on scheme-specific guidelines and are implemented by State governments or their designated agencies. The Central assistance to State Plans has two components, *viz.,* normal Central assistance and additional Central assistance for externally aided projects and for special programmes based on specific criteria and guidelines. Grants from the Centre to the States as a proportion of total revenue receipts of the States increased from 16.8 per cent in the 1990s to 17.3 per cent during 2000-2010, primarily during the second half of the decade (18.3 per cent) on account of higher non-Plan grants under the Twelfth Finance Commission award as well as higher transfers under State Plans and CSS.

2.12 The proliferation of CSS and the need for counterpart funds has led to the pre-empting of the State government resources from their Plan priorities. In several cases, it has also led to difficulties in accessing CSS funds due to the shortage of counterpart funds from the States. States, particularly Bihar and Jharkhand and the North-eastern States, have often represented that they have resource constraints and are not able to provide their share to enable them to access the required funds under CSS. This is particularly important for schemes such as *Sarva Shiksha Abhiyan* (SSA) where the counterpart funds are required to be provided to the extent of 35 per cent and the sector is critical for every State.

Box II.1: Recommendations of the High Level Expert Committee on Efficient Management of Public Expenditure

In response to the conceptual issues relating to plan financing raised in the Eleventh Plan document, the Planning Commission constituted a High Level Expert Committee on Efficient Management of Public Expenditure (Chairman: Dr. C Rangarajan). The Committee submitted its report in July 2011. The Committee has recommended that while the process of preparing Five Year Plans may be continued, the distinction between Plan and non-Plan expenditure may be removed from the budgets of the Union and State Governments to present a more holistic view of expenditure rather than the present segmented view. Other recommendations of the Group include:

- One-to-one correspondence between the annual budgetary component of the plan of the Centre and States and the government budgets of the Centre and States, respectively.
- A shift in the budgeting approach from a one-year horizon to a multi-year horizon and from input-based budgeting to outputs and outcomes.
- Changes in organisational structure, mandates and processes as well as appropriate interventions in human resource development and information technology in order to accommodate the shift to holistic view of expenditure.
- Defining and delineating the role of the Ministry of Finance, the Planning Commission, administrative ministries and the State governments.
- Changes in the Annual Budget process.

Comprehensive Framework of Transfers to States

- A new multi-dimensional budget and accounting classification to present a comprehensive view of Central transfers to States.
- The proposed classification to provide uniform codes for central programmes, sub programmes and schemes being implemented in the States.
- The Central Plan Scheme Monitoring System (CPSMS) to be extended to enable tracking of expenditure for all central schemes using both treasury route and society route. This may require interface of CPSMS with core banking solutions of banks, systems of State treasuries and accountant general offices.
- Empowering citizens with information on the flow of resources and their utilisation through a portal, thereby promoting transparency and accountability.

Accounting Concerns Arising from Direct Mode of Transfer

- The treasury mode of transfer of Central Plan fund is recommended.
- A suitable accounting methodology to be worked out by Controller General of Accounts (CGA) and Comptroller and Auditor General (CAG) to distinguish between final expenditure and transfer.
- The switchover to complete treasury mode may be made from the Twelfth Five-Year Plan for all new schemes, with a short transition period to allow for necessary adjustments to the existing schemes.
- Until the switchover is complete, accounting and submission of utilisation certificate under society mode to be rationalised.

Revenue / Capital Classification

- Revenue-capital classification to be continued. Capital expenditure should relate to creation of assets and be determined by ownership criteria.
- While all transfers should be treated as revenue expenditure in accounts, the merit of classifying revenue expenditure by end-use is also considered for FRBM compliance and grants for creating assets may be classified as capital grant.
- An adjusted revenue deficit is recommended only for the purpose of FRBM compliance. FRBM may require some amendments to allow for adjusted revenue deficit.

Scope of Public Sector Plan

- The Central or State Plan should continue to include investment outlays (funded by internal and extra budgetary resources) of Central public sector enterprises and States public sector enterprises, respectively. Consolidated information on the resources and expenditure of rural and urban local bodies may be provided as a special supplement to the budgets.
- The budgets and accounts of the implementing agencies should be shown as a supplement to the Budgets till funds are transferred through direct route.
- As regards public-private partnership (PPP), the annuity commitments may form a part of committed expenditure of the budget of the concerned Ministry/Department and annuity payments may be treated as capital expenditure.
- Viability gap funding is a grant provided to concessionaire of the PPP projects and may be treated as capital grant.
- There should be supplements to the budgets providing project-wise, ministry-wise and sector-wise information on the PPPs.

Source : Report of the High Level Expert Committee on Efficient Management of Public Expenditure, Planning Commission, Government of India, July 2011.

Simultaneously, it is also important to ensure that States have adequate financial participation to ensure a sense of ownership of the scheme. It has been argued that if 100 per cent grants come from the Central government, ownership gets diluted.

2.13 Other issues of concern to policy makers and implementing agencies over the years include lack of flexibility, accountability, enforceability and implementation. To address some of these concerns, the Planning Commission had constituted a sub-committee to look into the restructuring of CSS to enhance its flexibility, scale and efficiency. The Committee has recommended that the inter-distribution amongst States needs to be based on equitable notified criteria. It has also recommended that the linkage between Centre and State funding needs to be kept in mind while devising the criteria for distribution (Box II.2).

2.14 The ThFC had recommended that Central loans to States for CSS/Central Plan schemes through ministries other than the Ministry of Finance that were outstanding at the end of 2009-10 be written off. Accordingly, the Central government would be writing off the outstanding debt under these schemes amounting to around ₹21 billion during 2011-12.

Box II.2: Report of the Committee on Restructuring of Centrally Sponsored Schemes

The Central government has over the years introduced several centrally sponsored schemes (CSS) in areas that are national priority such as health, education, agriculture, skill development, employment, urban development and rural infrastructure. Several of these sectors fall within the sphere of activity of the State governments. States have been raising concerns at various forums about lack of flexibility in these schemes, the adverse implication of counterpart funding requirement of CSS on State finances and the questionable utility of operating large number of CSS with thinly spread resources at the field level. To consider the concerns of all stakeholders, the Planning Commission constituted a Sub-Committee in March 2011 (Chairman: Shri B.K. Chaturvedi) to suggest restructuring of CSS to enhance its flexibility and efficiency. The main recommendations of the Sub-Committee which submitted its report in September 2011 are given below.

- CSS with an average annual outlay of less than ₹1 billion (which at present accounts for 44 per cent of the total CSS) should either be weeded out or merged for convergence with larger sectoral schemes or alternatively be transferred to the States, which can then continue with these schemes based on their requirements.
- The existing CSS should be restructured into three categories, *viz.*, (a) flagship schemes which will address major national interventions required on education, health, irrigation, urban development infrastructure, rural infrastructure, skill development, employment and other identified sectors, (b) major sub-sectoral schemes to address developmental problems in sub-sectors of major sectors like agriculture, education and health, and (c) sector umbrella schemes, which will address the sectoral gaps to help improve effectiveness of Plan expenditure. Such restructuring will reduce the total number of schemes from 147 to 59.
- The distribution of CSS funds amongst different States should be based on transparent notified guidelines that should be put on the website of the concerned ministries. To incentivise the States to provide larger funds for certain sectors such as health, education, urban development, skill development and rural infrastructure, 50 per cent increase in the budget amount of the Central government department will be distributed amongst those States that have provided for an increase in their budget over the previous year in the concerned sector (excluding Central CSS/ACA funds).
- New CSS should focus only on major interventions required by national development needs. Such schemes should be flagship schemes (Category-I) and have a minimum Plan expenditure of ₹100 billion over the five-year Plan period. New schemes less than this stipulated minimum should either be part of the major sub-sectoral schemes (Category-II) or sector umbrella schemes (Category-III).
- The normal Central assistance to States should not be reduced to below 10 per cent of gross budgetary support (GBS) to enable States to have adequate, flexible and untied resources for their Plans.
- To enable State governments to meet their special needs, the design of CSS should be flexible and 20 per cent of budget allocation in all the CSS (10 per cent in flagship schemes), to be called ‘Flexi Funds’, should be earmarked in each scheme for this purpose.
- The evaluation of the CSS may be done by (a) professional institutions; (b) visits of experts to major project implementing States; (c) other individual experts by field visits. In addition, sample surveys may be carried out in selected States across the country to assess the impact and outcomes of the individual CSS. The Planning Commission should prepare a list of organisations that can conduct such monitoring and evaluation in States.

Source : Report of the Committee on Restructuring of Centrally Sponsored Schemes, Planning Commission, Government of India, September 2011.

6. External Borrowings

Why do States need to give special attention to their foreign currency denominated debt?

2.15 State governments cannot access external sources of finance directly. Based on the recommendation of the Twelfth Finance Commission, transfer of external assistance to non-special category States is being made on a 'back-to-back' basis[3] from April 1, 2005. For special category states (North-east States, Uttarakhand, Himachal Pradesh, and Jammu and Kashmir), external borrowings are in the form of 90 per cent grant and 10 per cent loan from the Central government.

2.16 The present arrangement entails the exposure of States to uncertain movements in both international interest rates on which the lending agencies benchmark their interest and currency exchange rates. As per the 'back-to-back' loan transfer arrangement, States have to bear the currency risk since principal repayments and interest payments on such loans to external agencies are denominated in foreign currencies. In case of significant rupee depreciation, larger provisions may be required to meet debt service obligations that may negatively impact the fiscal health of the State concerned. Three States (Andhra Pradesh, Tamil Nadu and Madhya Pradesh) accounted for over half the outstanding loans denominated in foreign currency as on February 29, 2012, with Andhra Pradesh alone accounting for over one-fifth.

2.17 The recent increase in global uncertainties has raised both interest rate and exchange rate risks, with the latter assuming more serious proportions in the light of the sharp depreciation of the rupee in the during September – December 2011. This underlines the need for capacity building by the State governments to ensure that debt denominated in foreign currency is prudently managed. The currency risk needs to be factored in while weighing the costs of domestic borrowing *vis-a-vis* that of external borrowing.

7. Losses of State Power Utilities

What are the factors affecting financial conditions of power utilities and how do they impact State Finances?

2.18 A growing area of concern for the States is the significant increase in financial losses of the State power distribution utilities which carry both a direct as well as an indirect burden on the finances of State governments. Besides budgetary support to the SPUs through subsidies, grants and loans, the States also extend guarantees for loans taken by the power utilities from financial institutions. SPUs are making huge cash losses due to non-revision of tariffs over extended period of time on the one hand, and non-realisation of subsidies from the State government, on the other. The deterioration in financial performance of SPUs is expected to have significant implications for the finances of States.

2.19 Power sector reforms and the unbundling of power utilities have not had the desired impact on the financial position of the power utilities or the State governments. Subsidies to SPUs/State Electricity Boards (SEBs), which have been rising over the years, were high in 2009-10 for Gujarat and Karnataka which had unbundled utilities as well as for Tamil Nadu where the power utilities had remained in bundled form until 2009-10. Net loans to SEBs/unbundled SPUs were high for Madhya Pradesh, Bihar and Jharkhand. Only a few States separately reported guarantees extended to SPUs.

2.20 The gap between the average cost of supply and average revenue (with and without subsidy) realised has widened in several States as the tariff

[3] Passing loans from bilateral and multilateral sources on 'back-to-back' basis to State governments implies that States face identical terms and conditions (including concessional interest rates, grace period, maturity profile, commitment charges and amortisation schedules) as is faced by the Central government.

revisions to close the gap do not take place regularly. Pending tariff revisions, the SPUs resort to borrowing from banks and financial institutions to cover their losses. The accumulated borrowings and interest payments add substantially to the average cost of supply and create further pressure on the financial position of the SPUs. The non-payment of subsidy to SPUs by some State governments also complicates the situation. Although the share of loans from the States as a proportion of total borrowings of the power utilities and subsidy realised (subsidies received as a proportion of subsidies booked) have been declining in recent years, the increase in State government guarantees to these utilities has increased the contingent liabilities of the States.

2.21 As SPUs have increasingly financed their losses through short-term borrowings from banks and other financial institutions, these borrowings have assumed alarming proportions. In this context, the Planning Commission had appointed a High Level Panel (HLP) on 'Financial Position of Distribution Utilities' in July 2010 to look into their financial problems and to identify corrective steps. According to the report submitted by the HLP in December 2011, over 70 per cent of the accumulated loss (adjusted for subsidy) of ₹820 billion of the distribution utilities between 2005-06 and 2009-10 was financed by public sector banks, 42 per cent of which was backed by State government guarantees. The cushion available in the form of States' guarantee redemption funds at ₹40 billion to meet the commitment arising from possible default is grossly inadequate. The HLP has made several recommendations which *inter alia* include setting up of a special purpose vehicle to address the issue of repayment default by SPUs (Box II.3).

2.22 Arrears on subsidy are not captured in the State Budgets as the budgets follow cash accounting as opposed to accrual-based accounting. Information on unpaid subsidies, loans extended against State government guarantees/letters of comfort as also guarantees invoked, if any, should be transparently reported by the State governments.

8. Public Private Partnership (PPP) at the State Level

With policy emphasis on removing bottlenecks and incentivising the implementation of PPP projects, what disclosures should the States make for transparent assessment of the associated liabilities?

2.23 Recourse to the PPP mode for project financing is generally encouraged because it frees valuable fiscal space for the provision of public goods in areas where such financing may not be forthcoming. PPP projects in sectors that come under the purview of the State governments such as urban amenities, State highways and minor ports have increased in recent years. Some States like Maharashtra, Andhra Pradesh, Karnataka and Gujarat have undertaken far more PPPs than others. While there has been a concentration of PPPs in the road sector across the States, there is greater diversity of PPP projects in certain States like Andhra Pradesh where, besides roads, PPPs cover sectors such as education, energy, forestry, health, information technology, minor ports, tourism and urban development. In terms of the main types of PPP contracts, almost all contracts have been of the build, operate and transfer (BOT) type or build, own, operate and transfer (BOOT) type (either toll or annuity payment models) or close variants.

2.24 With a view to incentivising PPP, the Government of India has formulated the draft Public Private Partnership (Preparation, Procurement and Management) Rules, including rules for regulating expenditure, appropriation of revenues, and contingent liabilities in PPP projects and proposed delegation of powers in this regard. The draft rules have been placed on the website for wider consultation with the stakeholders.

Box II.3: Report of the High Level Panel on Financial Position of Distribution Utilities – A Brief

The Planning Commission had appointed in July 2010 a High Level Panel (HLP) under the Chairmanship of Shri V.K. Shunglu, former Comptroller & Auditor General, to look into the financial problems of State Electricity Boards and to identify corrective steps. The terms of reference of this Committee included reviewing the accounts of state electricity boards and state distribution companies as at end-March 2010 and to project their losses by 2017; reviewing the electricity tariff and examining the role of the State governments, Electricity Regulatory Commissions and distribution companies in periodic tariff revisions; assessing system improvement measures accomplished in distribution of power and recommending a plan of action to achieve financial viability in distribution of power by 2017. The HLP presented its report to the Deputy Chairman, Planning Commission on December 15, 2011. The salient features of the Report are as follows :

- The accumulated losses of the distribution utilities during 2005-10 amounted to ₹820 billion after subsidy, of which nearly a third was incurred in 2009-10 alone.
- These losses are primarily on account of poor managerial and operational practices of distribution companies compounded by irrational tariffs fixed by regulators. There was a gap of about ₹0.60/kwh between average cost and revenue realised.
- Around 70 per cent of the financial losses of distribution companies during the past five years has been financed through loans from public sector banks. Of the total bank loans outstanding at ₹585 billion, only 42 per cent is backed by government guarantees.
- Recognising the limited scope for borrowings by the State governments to meet the debt obligations of distribution utilities to public sector banks, the HLP has suggested that to start with, banks need to jointly re-negotiate with distribution utilities/State governments the outstanding amount as also the recovery schedule taking into account the reform measures likely to be initiated by the distribution utilities and State governments. It is also suggested that the Reserve Bank should allow State governments to draw down the amount available in guarantee redemption funds (₹40 billion) to meet the liabilities of distribution companies to banks which are guaranteed by them.
- To address the issue of repayment default despite best efforts, it is suggested that a Special Purpose Vehicle (SPV) be set up for purchasing the loans of public sector banks to discoms, subject to several conditions which, *inter alia*, include periodic tariff revisions. However, if it is subsequently found that repayment default to banks occurred for reasons which were under the control of the distribution utility, the SPV mechanism would still be used to repay the bank but would entail concomitant debit of the account of the concerned State government with the Reserve Bank.
- It is recommended that 76 per cent of the share capital of the SPV would be held by the Reserve Bank while the Power Finance Corporation and the Rural Electrification Corporation would hold the balance. The Reserve Bank is also expected to extend a line of credit to the SPV.
- State Electricity Regulatory Commissions should be made independent financially as well as in their functioning. The selection of Chairman and members of Electricity Regulatory Commissions needs to be fine-tuned and further, their functioning should be scrutinised by an Expert Group to determine to what extent the Commissions have discharged their statutory duties such as timely and regular revision of tariffs.
- In areas where losses are high, a loss surcharge should be imposed over and above the basic tariff.
- Other recommendations include introducing input-based franchise models in about 255 more towns as listed in the Report, the cautious use of Section 108 of the Electricity Act, 2003 relating to the issue of policy directions and proper energy accounting of all consumers.
- Distribution losses are projected to decline from around ₹280 billion in April 2010 to around ₹220 billion at end-March 2017. These projections are based on a number of assumptions including the expectation that States will make concerted efforts to eliminate losses and that commercial losses would be substantially reduced by the end of the third year of the Twelfth Five-Year Plan.

Source : Report of the High Level Panel on Financial Position of Distribution Utilities, Planning Commission, Government of India, December 2011.

2.25 As noted by the ThFC, PPPs create explicit and implicit obligations of the public entity that is involved in them. While explicit contingent liabilities in the form of stipulated annuity payments over a multi-year horizon may be spelt out, implicit contingent liabilities are obligations to compensate the private sector partners for contingencies such as changes in specifications, breach of obligations and/or early termination of contracts which may be difficult to quantify. As recommended by the ThFC for the Central government, there is also a need for the States to quantify expenditure obligations relating to PPP projects in their medium-term fiscal policy statements with an increasing number of them adopting the PPP mode of project implementation.

9. Conclusion

2.26 The budgeted fiscal stance of the State governments during 2011-12 is generally in consonance with the revised road map of the ThFC. There is, however, a need to deal with the different structural constraints, particularly for States which could not achieve fiscal consolidation. The strategy towards integrated management of the overall expenditure enveloping various functions of the government for facilitating desired outcomes, as recommended by the High Level Expenditure Committee on Public Expenditure, is welcome. Successful restructuring of the public expenditure management system would, however, call for appropriate assimilation of the new system across the government machineries at all levels. An important fiscal challenge for the States is significant increase in financial losses of the State power distribution utilities which carry both direct and indirect burden on the finances.