Box 2. Zambia: Electricity Sector Reforms

ZESCO, the state-owned electricity company, is financially weak and represents a significant fiscal risk (MEFP ¶59). The company has elevated operating costs largely driven by purchase agreements with IPPs and high labor costs. It has also had significant capital investment needs in recent years. However, electricity tariffs and fees are currently below cost-reflective levels, leading to the accumulation of significant losses during 2018-20. These losses also reflected the need to import electricity during the 2019 drought and the kwacha's depreciation during that period. Consequently, all of ZESCO's debt—both explicitly guaranteed and non-guaranteed—is included in the measure of PPG debt used in the DSA. As of end-2021, ZESCO's debt amounts to about $1.5 billion in loans (including to finance the Kafue Gorge Lower hydro project), on top of $1.4 billion of payables outstanding to local and external IPPs.

In December 2020, the ZESCO board approved a turnaround strategy to help restore the company's financial viability (MEFP ¶60 and ¶101). Introducing cost-reflective tariffs—while maintaining lifeline tariffs for low-income households—is expected to address ZESCO's chronic revenue shortfall. Operating costs are expected to be curtailed through re-negotiated power purchase agreements and a voluntary separation scheme to support a reduction in labor costs. Capital expenditures will also be optimized, including through a review of non-committed investment projects. The government is planning to initiate a process of optimizing and strategically divesting ZESCO's operating assets in 2023. Finally, ZESCO's external debt is expected to be included in the restructuring operation which will help improve the company's balance sheet structure.

Efforts to boost revenue collection and reduce operating expenses are already yielding early results. In 2021, ZESCO recorded a substantial operating profit, with overall earnings also benefiting from kwacha appreciation. Introducing a multi-year tariff framework (MYTF) that will restore cost-reflective tariffs, and ensure future tariff adjustments when underlying cost conditions change, will be critical to a more durable recovery (structural benchmark). Such a framework will be based on the recently completed Cost-of-Service Study (COSS). To inform the authorities' response to the COSS, key stakeholders were invited to review the study. Once Cabinet has approved the response, which will also outline the authorities' policy intentions with respect to the MYTF, they will publish both the COSS and their response (prior action). At that point, ZESCO will request the adoption of the MYTF from the Energy Regulation Board (ERB). That will be subject to a public consultation before the ERB can make its decision.