

Powering Forward

Why Unbundling the CEB is Critical for Sri Lanka's Energy Future

A POSITION PAPER

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ADVOCATA

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A position paper on selected proposed amendments to the Electricity Act No. 36 of
2024

Introduction

Sri Lanka's electricity sector has long suffered from inefficiencies and financial losses due to the centralized, state-dominated structure of the Ceylon Electricity Board (CEB). After several attempts to reform the sector over the years, the Sri Lanka Electricity Act, No. 36 of 2024 sought to address these inefficiencies by unbundling the CEB into 12 entities, opening more space for private investment and effective regulation.

However, a proposed amendment in 2025 seeks to reverse this direction by consolidating the sector into just six entities and retaining full state ownership of generation, transmission, and distribution. This position paper outlines three reasons why Sri Lanka should reconsider this shift toward re-centralization:

- A. The country's current fiscal and investment constraints demand private capital;**
- B. Unbundling utility functions brings proven economic benefits; and**
- C. Strategic national interests can still be safeguarded without full state ownership.**

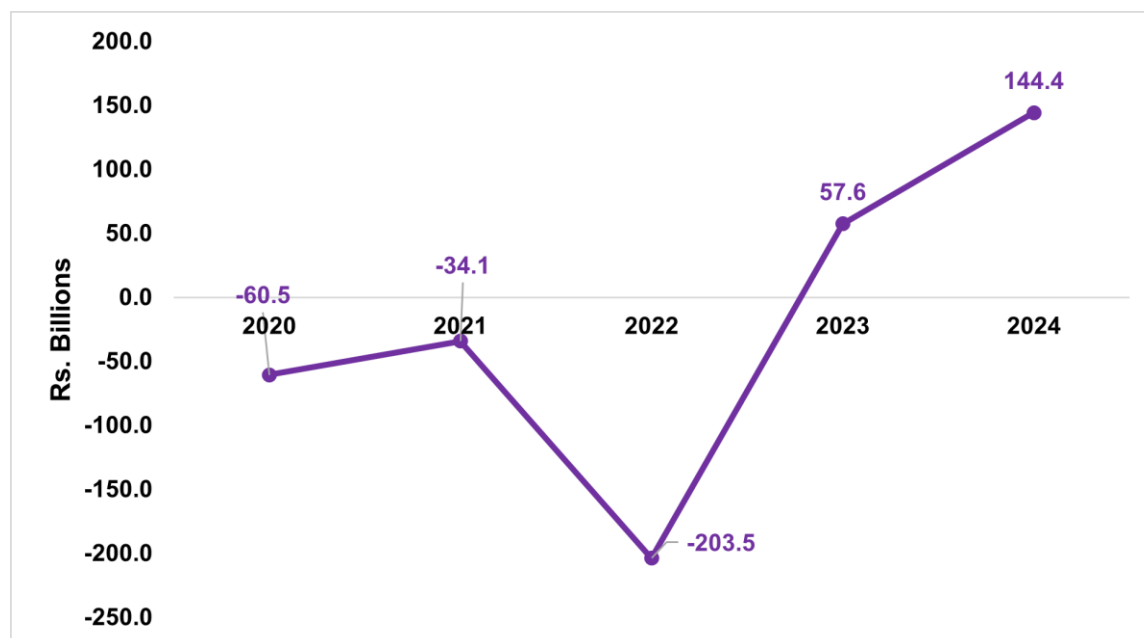
Consolidating control of the electricity sector under state monopoly risks deterring investment, weakening regulatory oversight, and reinforcing inefficiencies. Instead, Sri Lanka should stay the course on reform, fostering a transparent, accountable, and competitive energy sector that is better equipped to meet future demands.

Why CEB Reform Matters:

Sri Lanka's electricity sector is plagued by financial losses, underinvestment, and inefficiencies due to its vertically integrated, state-controlled structure. The Advocata Institute has previously emphasized the need for reform in the CEB due to its consistent losses and consequent burden on the country's fiscal health. Over the years, the burden of CEB's losses have been reflected on the government's balance sheet, contributing to balance of payment crises in the past.

Following two downward tariff revisions in 2024, the CEB recorded a net profit of Rs. 144 billion in 2024, compared to Rs. 58 billion in 2023. However, after a 20% tariff reduction at the start of 2025, the CEB posted a loss of Rs. 18 billion in the first quarter alone. This is in sharp contrast to the profit of Rs. 63 billion reported during the same period in 2024¹, when higher tariffs and an appreciated rupee bolstered performance. These extreme profit and loss figures have less to do with the CEB's operational efficiency, and are largely the result of flaws in the current price-setting methodology, where inaccuracies in forecasting (due to varying uncontrollable factors like the weather, electricity demand etc.) lead to temporary surpluses or deficits in monthly accounts which must later be clawed back. To minimise such fluctuations, a more transparent, formula-based tariff mechanism, updated at regular intervals, and overseen by an independent regulator could help smooth out these variations and provide price stability without needing to rely on ad hoc adjustments.

¹<https://economynext.com/sri-lankas-ceb-makes-rs18bn-loss-in-march-quarter-after-regulator-cuts-price-221012/>
https://cdn.cse.lk/cmt/upload_report_file/2216_1747310791560.pdf

Figure : CEB's Operating Profits/Losses Over the Years

Source: Annual Report 2024, Ministry of Finance

While reforms to the tariff-setting framework are clearly needed, it is not sustainable for the CEB to rely primarily on tariff adjustments to maintain profitability. The broader impact of accumulated CEB losses (driven by this approach) on public debt cannot be overstated. For example, in 2023 the Treasury injected Rs. 126 billion into the CEB to settle outstanding debts to the Ceylon Petroleum Corporation and Independent Power Producers (IPPs)². Further, although the CEB has been reporting operational profits for the last 2 years, the Ministry of Finance attributes this to key reforms introduced to the sector, including cost-reflective pricing for electricity, restructuring of balance sheets of the CEB through the transfer of legacy debts to the Government balance sheet, appreciation of the rupee, and settlement of liabilities etc.³ In February 2025, Cabinet approval was given to settle the CEB's remaining legacy debt estimated at about Rs. 182 billion⁴. The repayments were to start in April 2025 and were to be included in the electricity tariff calculation starting from the next tariff revision, thus ensuring the

² Ministry of Finance Annual Report, 2023

³ Ministry of Finance Annual Report 2024

⁴ Third Review Under the Extended Arrangement Under the Extended Fund Facility, Financing Assurances Review, and Monetary Policy Consultation Clause (IMF Country Report No. 25/56) reports this figure as **301 billion (as of September 2024)**.

repayment of old CEB debt by the government, partly recovered through consumer electricity bills⁵. The CEB's reliance on borrowings from domestic state banks, often backed by Treasury guarantees, has triggered additional contingent liabilities for the government, placing further strain on Sri Lanka's debt sustainability.

If instead of the state, a private investor (through public private partnerships, partial divestiture etc.) bore the risk of such losses, the burden on public finances could be reduced: the investor would retain profits when costs are well-managed and absorb losses when they rise, creating a stronger incentive for efficiency and accountability.

Beyond the issue of losses tied to tariff misalignment, there are deeper structural inefficiencies that cannot be ignored. The CEB's high generation costs, for example, are symptomatic of poor decision making over the years. These include an alleged reluctance to integrate cost-effective renewable energy and storage solutions⁶, as well as the premature onboarding of LNG infrastructure without a clear pricing or demand strategy⁷. While difficult to quantify precisely in a non-competitive environment, these inefficiencies, especially what economists call "X-inefficiency", suggest that total costs are higher than they need to be due to the absence of competitive pressure.

Compounding this problem is the current ownership structure of the CEB, which severely limits the regulator's ability to drive meaningful reform⁸. As long as the utility remains fully state-owned and vertically integrated, the regulator is largely restricted to cosmetic interventions (e.g., disallowing excessive employee allowances or bonuses) which would have limited impact on tariffs⁹. As a result, structural inefficiency remains entrenched, ultimately reflected in higher electricity costs for consumers and greater fiscal exposure for the state.

⁵ Third Review Under the Extended Arrangement Under the Extended Fund Facility, Financing Assurances Review, and Monetary Policy Consultation Clause (IMF Country Report No. 25/56)

⁶ <https://www.dailymirror.lk/breaking-news/CEB-accused-of-blocking-renewable-energy-to-push-thermal-power-a-growing-energy-mafia/108-309993>

⁷ <https://economynext.com/sri-lanka-revives-lng-terminal-tender-to-run-from-2028-minister-226027/>

⁸ Although there are many reforms needed within the regulator, the focus of this paper is on the CEB.

⁹ <https://www.ft.lk/columns/Can-State-owned-CEB-be-effectively-regulated-unless-restructured/4-738658&sa=D&source=docs&ust=1751434371908835&usg=AOvVawlgCd76qyldBAe0ydgugqx4>

CEB Reforms Over the Years:

The Ceylon Electricity Board (CEB) was established under Act No. 17 of 1969 as a vertically integrated monopoly, taking over from the Government Electricity Department (established in 1927). It was tasked with handling generation, transmission, distribution, and supply of electricity across the country. At the same time, many local authorities (municipal, urban, town and village councils) continued to be electricity distributors. Initial steps toward reform began in 1983 with the creation of Lanka Electricity Company (LECO), followed by the entry of private power producers in 1996. Although the CEB was administratively unbundled in 2000 into separate divisions for generation, transmission, and four regional distribution areas, this restructuring remained nominal, with no legal or financial separation¹⁰.

Formal reform began with the Electricity Reform Act No. 28 of 2002, which proposed breaking up the CEB and LECO into separate, state-owned companies and established the Public Utilities Commission of Sri Lanka (PUCSL) to regulate the sector. However, due to resistance from CEB staff, political pushback, and a change in government, the necessary ministerial order to operationalize the Act was never issued, stalling the reform¹¹.

In 2009, the Electricity Reform Act No. 28 of 2002 was repealed and replaced by the Sri Lanka Electricity Act No. 20 of 2009, which mandated that all operators, including the CEB, obtain licenses from the PUCSL and introduced ring-fencing of the CEB's operations into function-based business units. While these changes introduced regulatory oversight and internal accounting separation, the deeper reforms envisioned in the 2002 Act, such as legal unbundling, were abandoned. The CEB remained largely intact as a vertically integrated utility¹².

By 2022, repeated crises and mounting economic pressures renewed urgency for reform. The Cabinet appointed a Power Sector Reforms Committee to chart a new path focused on clearly separating the roles of owner, operator, and regulator. Fast forward to 2024, the Sri Lanka Electricity Act No. 36 of 2024 was enacted to separate the generation, transmission, and distribution functions of the Ceylon Electricity Board (CEB), with the goal of improving operational efficiency and attracting private capital.

¹⁰ Assessment Of Power Sector Reforms In Sri Lanka (ADB, 2015)

¹¹ Ibid

¹² Ibid

However, in December 2024, the Cabinet of Ministers approved a proposal to revisit the Electricity Act. In May 2025, a bill was introduced to Parliament proposing amendments aimed at re-merging these functions under 100% state ownership and control. Some of the key changes proposed under this amendment are summarized below:

Component	Original Act (2024)	2025 Amendment
Generation Structure	4 generation companies split by technology (hydro, coal, thermal, wind, etc.) Hydro- 100% state owned Coal- private Thermal- private Wind-private	1 consolidated "Generation Company" formed first (100% state owned); unbundling deferred to final transfer plan
Distribution Structure	4+ separate distribution companies formed immediately, based on CEB divisions and LECO – private companies	One consolidated "Distribution Company", 100% state owned absorbs all CEB divisions + LECO; future unbundling deferred
Transmission Network (NTNSP)	1 state-owned (at least 51%) company formed to own and maintain national grid Private companies will also be allowed to obtain a transmission license to develop and expand the transmission infrastructure	Same, but must now be 100% government-owned No private companies will be allowed a transmission license to develop and expand the transmission infrastructure New amendment also proposes to take over LTL Holdings and Lanka Energies Pvt Ltd
National System Operator (NSO)	1 state-owned company (100%) to manage dispatch, planning, procurement	Same entity with expanded authority (now drafts & maintains grid code)
Residual Companies	2 entities created for unallocated assets, pension/EPF management – both 100% state owned	Same, but Minister now appoints Boards, with defined policy obligations

In this context, Advocata Institute puts forth the following reasons for why Sri Lanka should reconsider the amendment's strategy of retaining full state ownership of these functions.

A. Sri Lanka's Challenges Demand Private Capital

It is important to recognize why retaining full state ownership, and thereby limiting private capital participation, is a high-risk strategy for Sri Lanka at this juncture. The country's current fiscal, demographic, and financial context creates both challenges and opportunities that make a compelling case for reducing state ownership and actively enabling greater private investment in the electricity sector:

- **Severity of Post-Crisis Fiscal Constraints Limits Public Investment Capacity**

Following Sri Lanka's economic crisis and sovereign debt default in 2022, and its subsequent entry into an Extended Fund Facility (EFF) program with the International Monetary Fund (IMF), the country stands at a critical juncture in restoring fiscal discipline and achieving long-term debt sustainability. A key driver of the crisis was the persistent widening of Sri Lanka's fiscal deficit. To address this, the government has enacted several reforms, including the Public Financial Management Act, No. 44 of 2024, which caps primary expenditure at 13% of GDP, while the Medium-Term Fiscal Framework (MTFF) sets a target of 2.3% primary surplus in 2025, to be maintained over the medium term – key to managing debt rollover risks.

In 2024, Sri Lanka recorded a primary surplus of Rs. 649.6 billion (2.2% of GDP), up from 0.6% of GDP in 2023. This was driven by strong revenue performance (13.7% of GDP in 2024, up from 11.2% in 2023) and restrained expenditure. Crucially, capital expenditure dropped by 15% to Rs. 776.6 billion, reflecting rigidities in recurrent spending (which was 1.3x total revenue in 2024). Interest payments alone consumed 65.7% of revenue, with subsidies, wages, and goods and services comprising nearly all the rest¹³. Public investment has already declined from Rs. 1,014.3 billion in 2022 to just Rs. 817.1 billion in 2024 (2.7% of GDP)¹⁴. In this environment, the state cannot feasibly undertake large-scale infrastructure spending in the electricity sector without crowding out other priorities.

¹³ Ministry of Finance Annual Report 2024

¹⁴ Ministry of Finance Annual Report 2024

Moreover, new investment by state-owned enterprises (SOEs) like the CEB is itself a fiscal trade-off. While SOE capital expenditure may not appear directly in the government's capital budget, it affects the fiscal envelope by reducing potential dividend flows to the Treasury. Capital allocation decisions by SOEs are thus a choice between reinvestment and dividend declaration. Historically, government liabilities (through debt or guarantees) have financed SOE capital, meaning these entities must generate returns that at least match the government's cost of borrowing, currently around 9%. Further SOE borrowing would worsen public debt dynamics and jeopardise the country's ability to maintain its primary surplus and meet IMF targets.

This also highlights a broader point: although SOEs like the CEB are not strictly part of the central government budget, their financial decisions significantly impact the state's fiscal health. As the Treasury absorbs SOE losses or converts debt to equity, the burden ultimately lands on the public balance sheet. Thus, attracting private capital into commercially viable segments like generation and transmission is essential to preserving fiscal sustainability.

• **SOE Borrowing Adds to Public Debt and Undermines Credit Ratings:**

Following Sri Lanka's sovereign default in 2022, the path to restoring creditworthiness has proven to be a gradual and complex process. In the immediate aftermath of a default, sovereign credit ratings typically remain in deep speculative territory, reflecting ongoing concerns over economic stability, institutional credibility, and long-term debt sustainability, even amid restructuring efforts. Upon successful completion of debt restructuring, modest rating upgrades may follow to acknowledge reduced short-term liquidity risks and a more sustainable debt outlook. However, such improvements are often incremental, as structural vulnerabilities and policy uncertainties persist. As of now, Sri Lanka's credit rating stands at Caa1¹⁵, indicating obligations of poor standing and very high credit risk, an improvement from Ca, which reflects obligations that are highly speculative and near default, recorded around the same period in 2024. Sri Lanka cannot afford to weaken this rating, as it will increase borrowing costs and ability to access debt in capital markets and jeopardize the country's ability to refinance restructured debt due from 2028/2029.

¹⁵ <https://ratings.moodys.com/ratings-news/435047>

Outstanding central government debt rose marginally to Rs. 28.7 trillion in 2024, with 64% (Rs. 18.3 trillion) in domestic debt. Much of this is linked to borrowing by SOEs like the CEB. As a result of the PUCSL regulating prices well below cost levels over the years, entities like the CEB had no choice but to borrow from the Treasury or from state-owned banks, under protection of a letter of support or guarantee from the Treasury, to provide a minimum level of liquidity¹⁶. These debts do not generate returns to the state; CEB alone owed Rs. 253.7 billion to domestic banks by end-2024¹⁷.

However, the CEB can no longer rely on the issuance of treasury guarantees to obtain loans to finance deficits. Under the amended¹⁸ Banking Act No. 30 of 1988 and the Central Bank of Sri Lanka's (CBSL) March 2024 directive¹⁹, licensed banks are restricted from exceeding large exposure limits (25% of Tier I capital per borrower; 55% in aggregate). Facilities previously extended to SOEs²⁰ through licensed banks under "national interest" or local infrastructure exemptions are now required to gradually reduce these exposures according to a transitional plan outlined in the directive. Similarly, banks with exposures to public corporations that exceed specified aggregate limits must reduce these exposures to comply by 31 December 2030, following a phased plan communicated by CBSL.

In addition, the Public Debt Management Act No. 33 of 2024²¹ imposes tighter restrictions on the issuance of government guarantees. Guarantees will only be granted to entities that are not in financial distress, as determined by a credit risk assessment conducted by the Public Debt Management Office (PDMO). Based on this assessment, the PDMO is also mandated to price the credit risk and charge a guarantee fee to reflect the risk borne by the government. As a result, the cost of securing sovereign guarantees has risen sharply. For example, recent reports indicate that the CEB's request for a USD 50 million loan from the Asian Infrastructure Investment Bank (AIIB), backed by a government guarantee, would require the CEB to pay a 4.8% premium to the Treasury²². These developments underscore a significant shift, where SOEs like the CEB must now operate with stronger financial discipline, reduce reliance on state-backed borrowing

¹⁶ IMF Governance Diagnostic Assessment (2023)

¹⁷ Ministry of Finance Annual Report 2024

¹⁸ As amended by Banking (Amendment) Act No. 24 of 2024

¹⁹ Under CBSL Directions No. 01 of 2024

²⁰ Under CBSL Directions No. 07 and 08 of 2007

²¹ Section 19 of Public Debt Management Act No. 33 of 2024

²² <https://economynext.com/sri-lanka-soes-face-4-8-pct-risk-premiums-for-sovereign-guarantees-harsha-222569/>

and start to focus on attracting new capital, further reinforcing the case for private sector participation.

Additionally, circular debt, in which one SOE owes another SOE, is compounding budgetary risks. For instance, the Ceylon Electricity Board (CEB) buys petroleum from the Ceylon Petroleum Corporation (CPC). Circular debt arises when entities within a supply chain owe payments to each other, but cannot settle their dues because the debts are indirectly linked through intermediaries. This creates a web of obligations where each party is both a debtor and a creditor. The issue is rooted in liquidity shortages, entities cannot manage cash flows effectively, leading to delayed payments. As one party defaults, it triggers a chain reaction of unpaid dues across the system, amplifying financial stress throughout the network²³. By end-2024, CEB owed the Ceylon Petroleum Corporation and IPPs Rs. 14.3 billion²⁴. Such cross-arrears undermine fiscal transparency, delay payments to suppliers, and weaken the financial viability of multiple SOEs across the value chain, pushing Sri Lanka into a deeper pit of deficit.

• Demographic Shifts Create Opportunities for Long-Term Capital

Despite current challenges, Sri Lanka's aging population presents an underexplored financing opportunity. By 2042, one in every four Sri Lankans is expected to be elderly²⁵. This demographic trend will increase demand for stable income sources during retirement, including returns from long-term investments. The most important income sources for older people are: (i) continued work; (ii) family support; (iii) income from assets accumulated during their lifetimes; and (iv) benefits received from government programs, financed either from general revenues or social contributions²⁶.

Electric utilities, particularly in transmission and distribution, are ideal for long-term, low-volatility investment. Globally, utilities are favored by pension funds due to predictable cash flows, lower systematic risk, and stable returns. In contrast to high-risk sectors like aviation, electricity utilities demonstrate modest earnings swings. This

²³ The State of State Owned Enterprises, Advocata Institute (2022) <<https://soeldev.wpengine.com/wp-content/uploads/2022/08/SoE-report-final-print-ready-1.pdf>>

²⁴ Ministry of Finance Annual Report 2024

²⁵ [https://www.statistics.gov.lk/Publication/SSR/DCSSSRVol2Issue1Article2#:~:text=While%20the%20elderly%20\(60%2B\),is%20expected%20to%20be%20elderly](https://www.statistics.gov.lk/Publication/SSR/DCSSSRVol2Issue1Article2#:~:text=While%20the%20elderly%20(60%2B),is%20expected%20to%20be%20elderly)

²⁶ Understanding Income Security for Older Adults: World Bank <<https://thedocs.worldbank.org/en/doc/98421347706d9fec936be71c0845479-0140022024/original/Understanding-income-security-for-older-adult.pdf>>

makes them attractive for annuity-like investments that can support ageing populations while financing infrastructure²⁷. For example, the South African Government Employees Pension Fund, the largest in Africa, holds an 18% stake in Sasol, a major energy and chemical company involved in diversified electricity and hydrogen projects²⁸.

Furthermore, if reforms in the electricity sector go through, and the subsequent productive efficiency gains in the sector begin to materialize, Sri Lanka has the potential to attract investments from such funds and groups in other countries. Attracting such capital would allow Sri Lanka to build out its grid without relying on constrained public finances or excessive borrowing, making a compelling case for partial divestiture or private participation in core segments of the electricity value chain.

²⁷ Annuities improve outcomes: Six client types who may benefit from an annuity (J.P. Morgan Asset Management) <<https://am.jpmorgan.com/content/dam/jpm-am-aem/americas/us/en/insights/retirement-insights/annuity-insights/annuities-improve-outcomes-paper.pdf>>

²⁸ Pension Funds: A Key Source for Financing African Energy Infrastructure <<https://energycapitalpower.com/pension-funds-a-key-source-for-financing-african-energy-infrastructure/>>

B. Unbundling the Electricity Industry Has Economic Merit

Restructuring or unbundling vertically integrated utility industries, such as electricity, typically involves two key steps: a) separating the potentially competitive segments (such as generation and retail supply) from the natural monopoly segments (such as transmission and distribution); and b) ensuring that all market participants, especially those operating in downstream segments (e.g., street lighting or electricity retail) have fair, non-discriminatory access to upstream infrastructure and services (e.g., generation and grid networks), which are considered essential facilities for competition to function effectively.

This separation is often done through the following 4 methods²⁹:

- **Structural separation:** Competitive and monopoly functions are provided by entirely separate legal entities, which may or may not be under common ownership (separate subsidiaries under the same corporate group). It is considered the strongest form of separation because it eliminates the incentive to favour affiliated companies.
- **Functional separation:** Different business units within the same organization manage competitive and monopoly functions independently, with measures to prevent anti-competitive behavior. This would mean that the personnel and operations of these entities would be separated (E.g., ring fencing measures, approved cost allocation methodologies etc.)
- **Accounting/Operational separation:** Although under common ownership, the utility maintains separate accounts for its competitive and monopoly functions, allowing regulators to monitor cross-subsidization and ensure transparency. This is considered the weakest form of separation.
- **Corporate separation:** This involves fully divesting a competitive or monopoly function so it is no longer part of the same corporate group. By removing ownership ties, it eliminates incentives for anti-competitive behavior and cross-subsidization. While it ensures maximum

²⁹ Sally Hunt (2002): Making Competition Work in Electricity

transparency and neutrality, it may be excessive or impractical where strategic coordination or public interests require integration.

Moves to unbundle, or restructure state owned utilities in sectors like electricity began in the late 1970s and gained momentum in the 1980s and 1990s. The first countries to have implemented this have been Chile in 1981, the UK in 1986 (for gas) and 1989 (for electricity), The US and the EU in the 1990s etc.

Concerns about the performance of vertically integrated firms (whether state-owned or regulated) prompted policymakers to introduce competition into the electricity and gas sectors. Often called liberalization, restructuring, or reform (and sometimes misleadingly referred to as deregulation), this process aimed to eliminate conflicts of interest and ensure that network decisions are made transparently and fairly, so that all market participants are treated equally. A prime example of this was the need to separate the planning process from the dispatch process, as a vertically bundled utility inherently faces a conflict of interest in managing both functions. By removing the advantage of network control from dominant firms, unbundling aimed to foster fair competition, encourage investment, and ultimately deliver better services and lower prices to consumers^{30,31}.

Although the effects of electricity unbundling in countries on the affordability of electricity for consumers (through end user prices) have been inconclusive³², their effects on the efficiency of service, network quality, operations and distribution/transmission losses in the sector has been positive. For example, electricity sector reforms in countries like Chile, Argentina, Brazil and India, which saw greater private investments, saw improvements in labour productivity, a reduction in total energy/distribution losses, and an improvement in total installed capacity (through investments), significantly improving electricity provision and service delivery in these countries³³.

³⁰ The Palgrave Handbook of International Energy Economics. Edited by Manfred Hafner and Giacomo Luciani (2022)

³¹ Reforming electricity reforms? Empirical evidence from Asian economies (OIES Paper EL 18). Oxford Institute for Energy Studies. (2016) <https://doi.org/10.26889/9781784670504>

³² Ibid

³³ Electricity reforms: What some countries did right and others can do better, Energy Sector Management Assistance Program, The World Bank (2012)
<<https://www.esmap.org/sites/esmap.org/files/DocumentLibrary/VP332-Electricity-Reforms.pdf>>

C. Ownership ≠ Control – Strategic Interests Can Be Protected Without Full State Ownership

A common justification for full state ownership in infrastructure sectors such as electricity is the belief that it is necessary to protect national strategic interests. Full government participation in markets has usually been justified only in narrowly defined circumstances, specifically, to advance national security, promote national development, or address clear market failures³⁴. Outside these contexts, state involvement has been known to have the potential to distort markets by undermining competitive neutrality³⁵, particularly when public enterprises benefit from preferential treatment in taxation, procurement, regulation, or debt guarantees.

Incorporating competition-neutral policies, such as regulatory neutrality, equal enforcement of procurement and tax rules (e.g., fines), and pricing of government guarantees not only helps to better regulate utilities like electricity, but also helps level the playing field between public and private firms. This is particularly important in sectors like electricity generation, where both state-owned assets and private Independent Power Producers (IPPs) operate side by side. Ensuring that public utilities are not given preferential treatment promotes fairer competition, enhances regulatory effectiveness, and leads to better outcomes for consumers.

Electricity, as a non-substitutable input, underpins nearly all modern economic activity. Its cost, reliability, and quality directly impact the competitiveness of downstream industries such as manufacturing, ICT, logistics, and retail. Frequent power outages, voltage instability, and price uncertainty discourage investment and hamper the growth of energy-intensive sectors – especially emerging industries like data centers and artificial intelligence. A competitively neutral electricity market is, therefore, not just a regulatory goal but a critical enabler of long-term economic development.

³⁴ Integrated State Owned Enterprise Framework: Sri Lanka Assessment, World Bank (2020)

³⁵ **Competitive neutrality** is achieved when no entity receives an undue competitive advantage or faces a disadvantage in the market; a level playing field must be maintained, ensuring that all businesses compete fairly regardless of their ownership structure.

To achieve this, Sri Lanka must move beyond the outdated notion that protecting strategic interests requires full state ownership. Strategic interests in critical infrastructure like electricity can still be protected through regulation, oversight, or partial ownership without burdening the state with full operational and financial responsibility. The institutional design of the regulator plays an important role in enabling this (see Box 1).

Box 1: Regulation of Utilities – The Importance of Institutional Design

Sound institutional design is fundamental to building trust in the regulatory process among investors and consumers. Effective regulation must be **credible, legitimate, and predictable**. Credibility means stakeholders believe that regulatory commitments will be upheld. Legitimacy ensures the regulator is free from undue influence by regulated firms or special interests. Predictability means regulatory decisions are consistent over time, allowing stakeholders to anticipate how issues will be resolved. To achieve these objectives, institutional design must rest on three pillars: a well-defined regulatory mechanism, an independent and capable regulatory agency, and accountability systems that deter favoritism and ensure transparency.

Independence and Accountability

A regulatory institution is considered independent when it operates under a legal framework and maintains arm's-length relationships with both private actors and political authorities. This includes organizational and financial autonomy that protects the regulator from external pressures. However, independence must be matched with accountability. Regulators are held accountable through transparent procedures and mechanisms such as public consultation, open decision-making, appeal processes, and clear communication of reasoning. Commissioners or directors typically serve in non-political roles and are appointed for fixed terms. Safeguards against corruption, conflicts of interest, and arbitrary dismissal further reinforce the regulator's integrity.

Accountability mechanisms include oversight by executive and legislative branches, courts, consumer associations, or supra-regulatory bodies. Tools for ensuring accountability may include stakeholder appeals to courts, clearly defined regulatory tasks and deadlines, publication and justification of decisions, the use of advisory and consultative bodies, and structured feedback channels. Additional safeguards include scrutiny by auditors and watchdog institutions, provisions for removing officials in cases of misconduct, budget transparency, and clear codes of conduct for directors. Transparency in these areas helps ensure well-reasoned decisions, consistent policy, and the public's right to understand how decisions are made.

Defining the Regulator's Role

A regulator's role is shaped by three key factors: the sectors it oversees, its relationship with policymakers, and its interaction with other regulatory bodies such as the competition authority. Depending on the context, regulatory agencies can be industry-specific, sector-wide, or multi-sector. The structure often reflects factors such as industry size, scarcity of skilled personnel, political context, decision-making capacity, and the complexity of industry boundaries. In some countries, regional regulatory bodies are created to reflect local conditions or legal traditions.

Regulatory agencies act on behalf of the government to address market failures. Their responsibilities typically include monitoring service coverage and network reliability, setting and enforcing service standards and pricing, supervising operators' compliance with obligations, resolving disputes, and advising on policy. They may also monitor competition, oversee financial performance, conduct auctions, and grant concessions. In some cases, regulators work in coordination with environmental or competition authorities. Clear mandates and procedures are essential for regulators to perform these functions effectively—particularly in ensuring fair access and promoting competition.

Organizational Structure and Capacity

Regulatory agencies may be structured around a board of directors appointed by the executive branch, sometimes with input from the legislature, or may be led by a single executive director. For optimal governance, directors must be independent of political powers, regulated firms, consumer groups, and other stakeholders. Given the technical complexity of regulatory issues, leadership and staff must possess specialized expertise and be selected through merit-based recruitment. Effective agencies invest in ongoing training, maintain a balanced mix of technical and administrative skills, and have access to high-quality outsourced expertise when needed.

Sustainable institutional capacity also depends on a competitive salary structure and access to independent financial resources. Financial autonomy helps shield the regulator from external pressures but must be counterbalanced with rigorous oversight by auditors and legislative bodies. Together, these structural and procedural elements enable regulatory agencies to function with integrity, competence, and public accountability.

Source: Body of Knowledge on Infrastructure Regulation³⁶

Global and local evidence shows that introducing competition, whether in the market or for the market³⁷ drives productivity improvements regardless of ownership. Some of

³⁶ <https://regulationbodyofknowledge.org/regulatory-process/institutional-design/>

³⁷ **Competition for the market** refers to when firms compete to become the sole provider of a good or service in a given market. Once selected (usually through a bidding or regulatory process), one firm is

the ways it does this is through disciplining managers to pursue operational efficiency (productive efficiency) and by spurring innovation through competitive pressure³⁸. These dynamics have been suppressed in Sri Lanka's electricity sector due to the vertically integrated, monopoly structure of the Ceylon Electricity Board (CEB), which controls the bulk of generation and distribution and holds a 100% monopoly on transmission. Furthermore, given the government's constrained fiscal space, full state ownership would mean accepting underinvestment in the energy sector as the inevitable reality for the foreseeable future.

Some have raised concerns that reducing state ownership and allowing competition for the market, particularly in transmission and distribution, could pave the way for private sector oligopolies or cartels. However, these risks do not justify blanket state ownership. Rather, they underscore the importance of robust regulatory frameworks that enforce competition, transparency, and accountability, irrespective of ownership.

What Sri Lanka needs is not full state control, but better governance structures that align incentives with performance and open the door to private capital and innovation in the generation, transmission and distribution segments of the industry.

● Generation:

Electricity generation is not a natural monopoly. Unlike transmission and distribution, which require large, capital-intensive networks with high fixed costs and are most efficient when operated as monopolies (or regional monopolies), generation can be competitively structured, and has been done in other countries. This is because generation technologies vary widely in terms of scale, cost structures, and operational management. Hydropower, coal, wind, and solar each have distinct technical and investment profiles, requiring different capabilities and long term strategies. Grouping these diverse technologies into a single, state-owned generation entity is economically inefficient, as it limits the ability to tailor management approaches and dilutes accountability. It also eliminates the potential for competition and specialization (e.g., decarbonization strategies or system flexibility) and reduces the potential to attract

granted exclusive rights to serve the market. Usually applies to natural monopolies like transmission.

Competition in the market refers to when multiple firms compete simultaneously within the market, offering similar or substitute products or services to consumers (e.g., electricity supply).

³⁸ Integrated State Owned Enterprise Framework: Sri Lanka Assessment, World Bank (2020)

investment, since most investors have specific preferences to invest in particular generation technologies.

In the case of Sri Lanka, hydropower is an exception, given large-scale hydro plants often serve multiple mandates of electricity production, drinking water and enabling irrigation, where irrigation and drinking water typically takes precedence. These major hydro assets may warrant continued state oversight due to their strategic importance through regulatory mechanisms or by maintaining majority ownership, rather than total control. However, other generation technologies as specified in the amendment (coal, wind, thermal) can be divested to or managed by private sector operators under regulation without compromising public interest. Since generation accounts for the largest share of overall electricity costs in Sri Lanka, restructuring this segment of the CEB to allow for market competition is essential. Competitive pressures would incentivize producers to reduce waste, adopt new technologies, and optimize operations, ultimately driving economic efficiency and ensuring electricity is produced at the lowest possible cost.

New Zealand's electricity generation sector³⁹ illustrates how strategic interests can be maintained without full state ownership. The country's generation market is dominated by four major companies: Genesis Energy, Mercury, and Meridian Energy, which operate under a mixed ownership model where the government retains a majority stake, and Contact Energy, a fully privately owned company. These generation companies own and operate power stations across the country, with most electricity produced in remote locations and transmitted efficiently to demand centers via the national grid. Over 200 generation plants supply electricity to the grid, with some smaller, embedded generation units feeding directly into local distribution networks.

In situations where the government deems it necessary to step in to ensure supply security, targeted public intervention has taken place without undermining the mixed ownership model. For instance, in 2004, the New Zealand government commissioned a 155 MW oil-fired reserve power plant at Whirinaki, Hawke's Bay, to provide backup generation during periods of low hydro inflows or major plant failures. Notably, while the plant was state-owned, Contact Energy⁴⁰ (a private company) was contracted to install

³⁹ <https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-generation-and-markets/electricity-market/electricity-industry#:~:text=users%20and%20businesses.-,Electricity%20generation,electricity%20sector%2C%20see%20Electricity%20statistics.>

⁴⁰ <https://www.mbie.govt.nz/assets/2ba6419674/chronology-of-nz-electricity-reform.pdf>

and operate it, demonstrating how public objectives can be achieved through partnerships with the private sector.

State control can still be ensured through 51% equity ownership, regulatory oversight, or strategic asset protection clauses—without reverting to full vertical reintegration, which crowds out private capital, disincentivizes efficiency, and reintroduces the inefficiencies that reforms were meant to correct.

• **Transmission:**

While transmission is indeed a natural monopoly due to its high capital intensity and network-based structure, 100% state ownership is not necessary to ensure its proper functioning or strategic oversight. In fact, as the CEB itself acknowledges,⁴¹ the government struggles to mobilize the required capital to upgrade and expand the national grid, limiting the country's ability to meet growing energy demand or integrate renewable sources efficiently.

Competition can still be fostered through well-structured concession agreements and transparent auctions (e.g., Public Private Partnerships). In this model, firms do not compete by duplicating infrastructure, but by bidding for the right to operate the network. This can take the form of (a) price-based auctions, where the firm offering the lowest retail price or revenue requirement wins, or (b) fee-based auctions, where the winning firm is the one that bids the highest franchise fee or lowest availability payment.

When a concession ends (either due to expiry or early termination) and a new firm wins the bid, the incumbent may be compensated for past investments, based on the contract terms. This could include the residual value of assets⁴², a regulated return on investment⁴³, or a net present value (NPV)⁴⁴-based termination payment. Such

⁴¹ Ceylon Electricity Board Annual Report 2022

⁴² Refers to the remaining value of an asset at the end of a contract, after accounting for wear and tear (depreciation). It's the portion of the investment that hasn't yet been "used up" and may be paid back to the company if the contract ends early.

⁴³ This is a pre-agreed profit that a company is allowed to earn on its investment, usually set by the government or regulator. It ensures that the company recovers its costs and earns a fair return for providing a public service.

⁴⁴ If a contract is ended early, this payment gives the company the current equivalent (today's value) of the future payments it was promised, adjusted for the time value of money. It's a way to fairly compensate the company for lost income.

frameworks create market-like incentives and pressure to deliver services efficiently, even within a monopoly⁴⁵.

Concerns about potential abuse of market position, such as overcharging, service denial, or delayed connections are addressed through strong regulatory oversight. Regulators retain the authority to revoke licenses or impose penalties on operators who violate service obligations. Moreover, concession contracts typically include performance benchmarks, financial guarantees, step-in rights, and asset reversion clauses, ensuring that control of the network remains with the public if operators fail to deliver. Disputes are resolved through legal mechanisms, not physical denial of service. In such an environment, private operators cannot “hold the grid hostage”; consumers are protected not by the goodwill of the concessionaire but by enforceable rules. What matters most is not who owns or operates the wires, but whether the system is governed transparently, regulated independently, and enforced effectively. The same goes for distribution operators⁴⁶.

Argentina’s transmission sector⁴⁷ provides a compelling example of how transmission, despite being a natural monopoly, can be managed through competition for the market (by functional and geographic segmentation) rather than full state ownership. The government sold its distribution and transmission facilities as concessions for 95 years.

The country has seven private transmission companies, with Transener playing the central role in maintaining and operating the national high-voltage transmission grid. In addition, five regional trunk transmission companies are responsible for intra-regional transmission, while a seventh company manages a project-specific line connecting the Yacyretá hydropower dam to the Buenos Aires region. Transener’s concession to operate Argentina’s high-voltage electricity transmission system was divided into nine management periods (an initial 15-year term followed by eight 10-year terms). At the end of each period, the concession would be re-auctioned via sealed bid. The incumbent operator could participate and would retain control only if it submitted the highest franchise bid. If not, it would lose the concession but be compensated with the winning bid amount. This structure was designed to allow the government to

⁴⁵ <https://regulationbodyofknowledge.org/market-structure-and-competition/competition-market/>

⁴⁶ <https://regulationbodyofknowledge.org/market-structure-and-competition/competition-market/>

⁴⁷ Gomez-Ibanez, J.A. and Rodriguez-Pardina, M.A. (2001b), Transener B: The First Tariff Review, CR14-01-1636.0 Kennedy School of Government Case Program.

periodically update concession terms while ensuring the current operator remained incentivized to invest in and maintain the grid.

Each of the above entities operate independently, and open access rules ensure that generators and buyers across regions could access the transmission infrastructure on equal terms, regardless of ownership. This structure demonstrates that with appropriate regulation and competition for the market, critical infrastructure can remain efficient, competitive, and inclusive- without relying on 100% state ownership.

To retain strategic control, the government can also adopt a 'golden share' model, which gives it veto power over key decisions such as capital structure, business profile, acquisition and mergers and dissolution etc. even if majority ownership lies with a private or mixed entity. This model has been successfully used in sectors considered critical to public interest, such as telecommunications and gas in the UK⁴⁸, where regulatory and policy interests are safeguarded without resorting to inefficient full state control.

• **Distribution (and supply):**

Like transmission, electricity distribution⁴⁹ is also considered a natural monopoly due to the high fixed costs and inefficiencies associated with duplicating network infrastructure in the same region. However, this does not justify consolidating all distribution functions into a single, state-owned entity.

Sri Lanka's own experience demonstrates the value of structural separation. Since the 1980s, the Ceylon Electricity Board (CEB) and the Lanka Electricity Company (LECO) have coexisted, showing that separation (even within public ownership) can yield better outcomes. The country is currently divided into 5 licensed regions for power distribution, supply, and sales. Of these, 4 licenses are held by the CEB, which covers more than 97% of the country and 91% of consumers. LECO, established in 1984 as a subsidiary of the CEB, manages distribution in the remaining areas, formerly served by local authorities, mainly along the western coastal belt between Galle and Negombo.

⁴⁸ Krishnaswamy, V., & Stuggins, G. (2003). *Private sector participation in the power sector in Europe and Central Asia: Lessons from the last decade* (World Bank Working Paper No. 8). World Bank. <http://hdl.handle.net/10986/15123>

⁴⁹ Electricity distribution networks transport electricity from high-voltage transmission networks to households and businesses for consumption.

Despite being publicly owned, LECO operates as a commercially oriented, performance-driven utility. It purchases electricity from the CEB transmission licensee and consistently demonstrates low technical and commercial losses (Partly owing to the advantage of the length of its transmission network compared to the CEB), higher billing efficiency, and superior service delivery, and their performance has been comparable to developed countries. Its success stems from its independence and commercial governance structure, which insulates it from broader government mandates, such as politically driven rural electrification⁵⁰.

The regulatory model allows LECO to retain surpluses by purchasing bulk power at a fixed price and keeping distribution revenues beyond cost recovery. This policy was formalized in the tariff regulatory structure introduced in 2011, which also extended similar ring-fencing provisions to CEB's internal distribution divisions. However, these have been only partially applied, as the CEB continues to use surpluses from its transmission and distribution arms to cover deficits in its bulk supply account. This obstructs financial discipline and stifles performance improvements⁵¹.

Reverting to a single, consolidated state-owned distributor as proposed in the 2025 amendment would deepen inefficiencies and weaken accountability. It would also erase the performance incentives that arise from benchmarking independent entities against one another, particularly given that in Sri Lanka, distribution companies are responsible for both distribution and supply functions and will continue to do so for the foreseeable future. Independent distribution entities create space for innovation and responsiveness to consumer needs, such as demand response initiatives, energy efficiency programs tailored to specific customer segments, community-level battery storage, and vehicle-to-grid technologies. These developments require operational autonomy, strategic flexibility, and a competitive environment. Importantly, independent distributors can still be effectively regulated through instruments such as price caps or revenue caps, as is done in Australia⁵², where five-year revenue determinations guide most distributors. Over time, introducing private capital into the distribution segment can pave the way for further reforms, such as unbundling the network (wires) from the retail (supply), enabling the emergence of competitive electricity markets similar to those in the EU or Australia.

⁵⁰ Assessment Of Power Sector Reforms In Sri Lanka (ADB, 2015)

⁵¹ Assessment Of Power Sector Reforms In Sri Lanka (ADB, 2015)

⁵² Electricity Distribution in Australia (Ibisworld, 2014) <<https://www.aer.gov.au/system/files/F7%20-%20IBIS%20World%2C%20IBIS%20World%20Industry%20report%20D2630%2C%20Electricity%20Distribution%20in%20Australia.pdf>>

What makes LECO effective is not its public ownership, but its incentive structure, governance model, and operational autonomy, which drive its performance and innovation. For instance, LECO has been quicker to roll out smart meters, enabling consumers to monitor and manage their electricity use more effectively⁵³. If Sri Lanka proceeds with the original plan to have four distribution companies, each with similar autonomy and structure, as opposed to one state owned distribution company, it could replicate the LECO model, creating “4 LECOs” rather than reinforcing the inefficiencies of a centralized monopoly.

⁵³ LECO Annual Report 2023

Conclusion:

Sri Lanka stands at a pivotal crossroads in its electricity sector reform journey. The 2025 amendment to the Sri Lanka Electricity Act, No. 36 of 2024, which seeks to reconsolidate generation, transmission, and distribution under full state control, risks undoing decades of progress and learning from both local and global examples. At a time when public finances are under severe strain, institutional credibility must be rebuilt, and long-term infrastructure needs are growing, rejecting private participation and unbundling is a high-cost strategy with low returns.

Global experience shows that efficiency, innovation, and investment in the electricity sector are best fostered not through centralized state monopolies, but through well-regulated, functionally separated structures that welcome competition and capital. Unbundling, in this context, is not just an institutional restructuring exercise – it is potentially the first step toward unlocking private investment at a scale not seen in Sri Lanka since the telecommunications reforms of the 1990s. This in turn can drive cost competitiveness and productivity across the economy. Reversing or delaying this process, and reverting to vertical integration under state control, risks locking Sri Lanka's energy sector into a cycle of underinvestment and inefficiency.

Sri Lanka does not need to choose between strategic interests and market reform – in fact, the two can and should coexist. A modern, financially viable electricity sector must rest on principles of transparency, autonomy, and accountability.

If Sri Lanka is to meet the twin challenges of fiscal discipline and energy security, it must move forward—not backward. Rather than reverting to a centralized, loss-making model, the government should move forward with bold, carefully managed reforms that embrace private sector expertise, preserve public interest through regulation, and replicate successful domestic models like LECO at scale (instead of absorbing or dismantling LECO). Unbundling is not only a solution, but it is a necessary step toward a more sustainable, resilient, and service-oriented energy future.

Powering Forward

Why Unbundling the CEB is Critical for
Sri Lanka's Energy Future



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