The Way Out?

Proposed changes to PPAs could help revive stressed assets

In a move to revive stranded generation capacity, the government is planning to modify the power purchase norms, whereby the fixed costs will be waived for discoms that enter into power purchase agreements (PPAs) with stressed power plants. The move will not only help project developers operate their stranded capacities but also provide guaranteed power to states at affordable prices. However, the execution of the plan will be crucial for the desired results. Sector experts share their views on the proposal and the key considerations in its implementation...

In your view, will the proposal to allow stressed projects to forgo their fixed costs encourage discoms to buy power from them?

P.N. Bhandari

In the commercial world, market forces play a key role. The logic of demand and supply cannot be brushed aside. Generators could dictate terms when there is a shortage of power. Fortunately for the country as a whole, and unfortunately for many generators, the situation has changed completely. Instead of a power shortage, we are facing a problem of large-scale backing-down of generating stations, arising out of a situation of surplus power. There has been a dramatic reduction in the cost of power procured from the power exchanges. Against this backdrop, stressed generators have very few options. They cannot survive for long without coal linkage from Coal India Limited. And for this, they need to have PPAs with distribution licensees, who would not like to enter into long-term commitments unless the terms and conditions of the generators are attractive. In this context, if fixed charges are waived, the generators have very little to lose. Earnings from variable charges are more crucial for the revival of projects, rather than the levy of fixed charges when the generating plant is not operating. This is a bold initiative of the power minister. Without such a way out, the condition of distressed projects would go from bad to worse. If this initiative is not taken up quickly, the economy will suffer. The financial institutions that have financed these distressed projects would also suffer. Hence, it is in the national interest to pursue this initiative on a war footing.

Rajesh Mokashi

The weak financial position of the discoms, subdued merchant power rates and decreasing solar power rates have put discoms in wait-and-watch mode with respect to the signing of fresh PPAs. In this context, the proposal stressed power projects voluntarily forgo their fixed cost would certainly find favour with the discoms. Lower/No fixed costs would lead to sizeable cost savings for the utilities, which are already financial by strained, owing to suboptimal cost recovery and high aggregate technical and commercial losses. Non-uniformity of demand is an essential feature of discom power planning periods of high and low demand. So, if discoms are free from paying fixed charges during periods of no demand, it would aid them in better operational and financial planning.

Arun Srivastava

Stressed assets have become a way of life in almost all infrastructure sectors in the country. It is mostly the result of an unrealistic assessment of market conditions, inadequate diligence or, at times, regulatory surprises. The power sector has also had its rather generous share of such assets, causing huge concerns. Tens of thousands of Mega Watt of generation capacity is stranded, either fully or partially, for various reasons, including lack of PPAs, fuel or even adequate capital (both equity and debt). While such assets are a concern for developers, they are of equal concern for the government, as the majority of the stuck funds are from public financial institutions. The total debt exposure to the power sector is about Rs 5 lakh crores, and almost 40 per cent of this is either completely or partially stressed and could turn into non-performing assets (NPAs) if the situation is not retrieved. The fate of such investments can be reversed only with enough demand for power at the procurers' end and the execution of PPAs for the purchase of electricity. Unfortunately, procurers seem quite reluctant to enter into long-term PPAs for several reasons, including high tariffs, demand uncertainties, technological interventions changing the market, long duration of PPAs and the need to take the responsibility of the fixed charges for the life of the PPA. Consequently, to avoid any such commitments, procurers stay away from signing new PPAs. Staying away from new PPAs also gets helped by the fact that the procuring states are currently quite comfortable in terms of power supplies. Since the

P.N. Bhandari
Former Chairman, Rajasthan Electricity Board

Rajesh Mokashi
Managing Director and CEO, CARE Ratings Limited

Arun Srivastava
Independent Power Professional

absence of PPAs renders power projects unusable, thereby causing financial stress, the power ministry has been exploring various ways to encourage states to enter into PPAs to make these investments productive. One obvious objective of such moves is to minimise potential NPAs. While the details of the scheme being put forward are not very clear, the proposal could have two possibilities:

- Power gets supplied to procurers as usual but during periods when supplies are not needed, procurers would be under no obligation to continue to pay the fixed charges
- The fixed charge component in the tariff is removed completely and there is only a single-part tariff, as it was in the 1990s or earlier.

Both situations could have different implications for the sector. If the scheme entails procurement of power under the restructured PPAs in a manner that allows procurers to pay fixed charges only during the period of supply and not otherwise, the situation would almost be like procuring power from the power exchanges, albeit under a PPA for a long term. In such a situation, the procurers may need to take a call on whether to go for procurement under a restructured PPA or through the power exchanges, given the price volatility. The effectiveness of the proposed measure would depend on the rates at which new PPAs would be committing power, given that procurers already have an alternative source in the form of power exchanges for a limited term and intermittent requirements. There will be a need for some commitment on the periods when the procurement would actually be carried out by the procurers as it would be critical for generators due to their limited flexibility on the technical minimum requirements.

Under the second alternative, where the tariff becomes "single part" and the fixed cost component is completely removed, a mechanism would need to be evolved to decide on the merit order, especially given the supply surplus situation in most of the procuring states. In this case also, since the procurement happens only during periods of short supply, the rates would need to be aligned with power exchange rates.

What are the key considerations that need to be taken into account while implementing such a mechanism?

P.N. Bhandari

Discoms are not totally free to procure power at mutually negotiated rates. The regulatory commissions have to regulate such purchases of distribution licensees under Section 86(1)(b) of the Electricity Act, 2003. The merit order has to also be followed for such purchases. If there is any conflict with the merit order, a directive may have to be issued by the concerned state government under Section 108 of the Electricity Act, to accommodate purchases from such distressed projects.

Rajesh Mokashi

In whichever form the proposal is implemented, it should benefit both the parties. Supporting one part of the value chain at the cost of the other would be counterproductive and would affect India's position as an attractive investment destination. In such a scenario, a few things should be kept in mind while finalising the contours of the scheme. First, discoms should purchase a minimum amount of power, which would give long-term revenue visibility to the generation company's cash flows. Also, the tariff should be such that it ensures some recovery of capital charge. New long-term PPAs under the proposed mechanism would help generation companies in securing coal linkages for which they may be willing to waive their return on equity, this offers them a reasonable level of debt servicing capacity.

From the discoms' perspective, scheme should be attractive enough to encourage them to tie up power on a longer-term basis, at a price that optimises their overall power purchase, while taking advantage of the declining renewables' tariff and subdued merchant rates.

Arun Srivastava

The considerations would depend on the objectives of the proposed scheme. If the objectives are only to help avoid NPAs and save the financial institutions, all that needs to be done is to make sure that the projects operate enough to meet the debt servicing obligations of the generators. But that would be a myopic view and the solution would be suboptimal. Eventually, the price would be paid by the sector and the economy. If the objective is to encourage the procurers to accept new PPAs, the restructured PPAs would need to offer significant flexibility in terms of procurement periods and a tariff that more or less reflects power exchange rates. Such an arrangement may not really work with the generators. It is easier to put the blame on the project developer and as a matter of punishment, restrict fixed charges recovery. Fixed charges not just include the return on equity but also have other critical components like depreciation, operations and maintenance expenses, taxes and interest payment. Complete or partial non-recovery of fixed charges puts the entire investment at risk. We must also bear in mind that even bad investment decisions happen primarily due to inefficiencies, and lack of application and diligence of the financial institutions. As the principal fund providers, it is their primary responsibility to make sure that all the I's are dotted and the T's are crossed, before permitting fund flows.

While the problem is huge, there are no easy solutions. Demand definitely needs to grow, but generation costs must also be aligned to the new emerging realities in the market, as better and cheaper supply sources are emerging to occupy the space of thermal power. Further, fixed charges comprise only 25-30 per cent of the total cost of generation; the remaining is the fuel cost and the share of return on equity is hardly 5 per cent of the total cost of generation. So what are we trying to squeeze? If a solution has to be found to make these investments viable, a comprehensive and ruthless review needs to be carried out and corrective steps taken. ■