



CIRC's observations and comments

On

"Preserving the Sanctity of Contracts:

The Case of Andhra Pradesh Renewable Energy Developers"

Background:

Andhra Pradesh, which sourced 18% of its electricity from renewable energy in FY19, plays an important role in the country's green growth narrative, as it comprises about 12% of India's wind and solar capacity. The state's aggregate technical and commercial losses — a benchmark for power pilferage and discom inefficiency — of 11% is one of the lowest among the country. Its discom losses stood at Rs 1,563 crore in FY19.

Over 3 GW of large-scale solar projects are operational in Andhra Pradesh with approximately 1.7 GW of projects under development, and about 200 MW tendered pending auctions. This case covers 82 projects involving 70 percent of the total installed wind capacity of 3965.87MW in the state. Of this, the projects with a combined capacity of 2348.25MW, or 60 percent of the total installed capacity, came into existence during the year 2016-17, when the preferential wind power tariff was fixed at the highest level of Rs 4.84 per unit by the regulator. The petitioners argued that the preferential tariff determined by the APERC and adopted for PPAs was unfair. The petitioner highlighted that the PPA price is higher compared to the price discovered in open bidding of projects conducted by SECI. This is causing huge loss to the discoms as it has to abide by the "must run" status of the renewable projects and has to provide them first scheduling priority in comparison to the other available cheap sources.

The state government also justified the renegotiation of PPAs alleging that the previous administration developed more than the mandated 5% Renewable Power Purchase Obligation (RPPO). The arguments that the financial distress of discoms is the result of high power tariff of RE projects do not hold any water and as such, renegotiation of PPAs is not the solution to the problem. There are other ways to deal with the poor financial condition of DISCOMs. Most DISCOMs in the country are in a similar or worse financial situation, but that should not enable them to revisit signed PPAs.

On this basis, the petitioner is asking for a review of the tariff set by the regulator from INR 4.70 per unit to INR 2.43 per unit and a reduction in the contract period to 5 to 10 years from 25 years. It seems that this is a case of pure political and not based on the principles of economics.

Current Situation of RE developers in Andhra Pradesh:

As per media reports¹, various developers claimed that they are not being paid the interim tariff as decided by the honorable high court of AP and the distribution companies are curtailing the power purchase from the RE developers citing low power demand due to pandemic and grid safety reasons. This has resulted in huge revenue loss for the generators owing to reduced generations. The generators are facing serious issues with debt servicing, managing the working capital and meeting other obligations arising out of RE. They have requested for an early hearing from the AP high court in this regard.

CIRC's observations and Views: On a larger perspective for the country

1. Policy certainty is an essential element for improving the economic environment and boosting investor confidence. A change in government should not necessarily mean a change in policies and previous decisions should not be overruled unless there are compelling reasons, which makes the decision void-ab-initio.
2. Apart from policy certainty, the sanctity of contracts is another significant area, which requires attention from lawmakers because our record is poor in this aspect. Annulling of contracts by a new government raises a big question mark over our commitment to sound jurisprudence, administrative credibility and affects the country's image adversely, no matter how much we improve our ease of doing business ranking.
3. Respecting a contract is important for the country because companies commit their resources for the long term based on plans and assessments formulated at the time of entering into the contract.
4. There is a financial dimension also to this issue, which is in the form of cost overrun and decline in the present value of return on investment. According to data released by the Ministry of Statistics and Programme Implementation (MOSPI) in September 2019, the cost overrun for projects over the specified limit (Rs. 150 crores) was to the tune of Rs. 3.88 trillion. The overruns leave a big hole in the government exchequer. Delay in the execution of the project affects the cash inflows in present value terms, which had been taken into account while signing the contract.
5. Infrastructure projects are financially structured on higher ratios of debt, reopening of contracts shake the lender's confidence, drying up long-term debt for infrastructure development.
6. Improvement in infrastructure is key to our economic development and India expects to invest over 1 trillion USD in this sector. This investment is not going to come entirely

¹ <https://www.livemint.com/industry/energy/andhra-pradesh-s-green-energy-investors-now-fear-loan-recall-11599638201228.html>

- from our domestic lenders and foreign funding would be required for major infrastructure projects.
7. Long gestation projects require absolute certainty to contractual obligations, mainly because of factors like the longevity of the project and the amount of money involved. However, if we build our image as a country notorious for dishonoring contracts upon the change in regime, nobody will do business with India.
 8. A delay in execution due to delay in fulfilling contractual obligations on the part of government also indirectly impacts the public, mainly in two ways viz. putting the money lent by public sector banks at risk and delay in delivery of public service.
 9. Though the recourse mechanism is always available in the form of court litigation or arbitration, but investors are more interested in making returns on their investment and litigation is the last resort, they would prefer.
 10. Arbitration and litigation take years for the courts to decide and by that time, the opportunity cost of reviving the stalled project becomes so large that investors prefer to abandon it.
 11. Ensuring transparency at the time of awarding the project and providing a safe and certain environment has to be the responsibility of the government.
 12. Sustainability of business very much depends on the sanctity of contract which must be respected at any cost unless under any force majeure conditions or environments beyond anyone's control.

Immediate fallout as is happening in this case:

1. Andhra Pradesh's decision to renegotiate Solar and Wind PPAs sets a bad precedent for the entire industry and the economy as a whole. Any type of renegotiation would affect the project's financials and affect the company balance sheet.
2. In this case, it is estimated that a debt exposure of around Rs 9,000 crore will be at potential risk if the state cuts tariffs on operational projects to bring it to current auction levels. It will not only impact the investment pipeline of Rs 60,000 crore in renewable energy projects in the state over the next 3-5 years but will also send a wrong signal to the investor community regarding the sustainability of renewable projects. This decision has already resulted in a collision course between the state government and the central government.
3. As foreign funds including major pension funds of the world are invested in India through renewable energy companies, it will send out a negative signal to the investors throughout the world and raises concerns on policy uncertainty and sanctity of contracts.
4. This not only weakens the entire bidding process but also leads to lower private sector confidence causing ongoing/future tenders being undersubscribed or cancelled resulting in projects not taking off in the future.
5. Renewable energy developers and investors face uncertainty as tariff renegotiation could lead to additional delays in payments from DISCOMs. Unpaid dues to the

renewable power generators stand at around ₹200 billion (~\$2.9 billion) with accumulated losses of about ₹150 billion (~\$2.2 billion). As far as the payments are concerned, wind and solar developers have not been paid in the last year.

6. There is a fear that if governments retroactively start negotiating old contracts demanding current prices, most of the industries in India would collapse.
7. The argument on tariff can be contested as it is known that the tariff for solar and wind generation in different states will be different depending upon many factors and the regulators have taken into consideration all such factors while announcing the preferential tariff.
8. Usually, the developers account for the risk of any delay in payments in the financial model. However, a risk of reduction in tariffs is not something developers have anticipated. The case of PPA renegotiation and the balance sheet issues have cascading effects on the developers as well as lenders' financial implications. The rating agencies have started downgrading the credit ratings of renewable energy developers that means, raising additional revenue would be going to be very difficult for them. This may also have an adverse impact on state's credit rating.
9. This could make matters much worse for the sector as lenders will not be willing to lend and the ripples will be felt through the length and breadth of the already sagging economy. The problem will be compounded along with NBFC crisis followed by rising NPAs in the industry.
10. This would lead to fear that the state governments would tweak the rules in its favour and may demand other doles like increasing transmission charges for open access projects.
11. States such as Punjab, Telangana, Tamil Nadu, and Rajasthan, which have also reportedly delayed payments to wind and solar developers, could start citing similar reasons and may want to renegotiate their PPAs.
12. It is to be noted that both SECI and NTPC have turned down the state's direction to lower the tariff for their projects and said that though the market saw a huge decline after two years or so, that does not mean a contract bound by law can be breached.
13. Eventually, the collision course would end up in courts and the judiciary will have to pronounce a final verdict on the same. Supreme Court has already ruled in favor of the sanctity of contract while denying compensatory tariffs to Adani and Tata Power in one of the earlier cases.
14. If at all, there is any concrete evidence of wrongdoing or corruption surfaces, the said contracts can be mutually discussed between the contracted parties to find a solution.
15. Investor confidence would be of paramount importance for the sector to grow as envisaged by the government and contracts such as the PPA, which are sacrosanct - need to be shielded from states dictating terms.
16. For the sake of sustainability, it must be noted that despite the electricity supply being a state-centric issue, contracts are completely based on the mutual consent of bidding

parties. India must be watchful of this growing tendency of states, which will jeopardize this very promising growth story.

The Way Forward:

However, in all these projects, if the government feels there is a requirement to change the procurement process, they would like to change the specifications of the contract for future projects. We accept the right of the state to change its policies and process. However, such a change cannot be retrospective in nature and should only be prospective. It is a settled economic principle that when the government changes its policies and principles, the projects, which have been awarded under the earlier policies, are “grandfathered” and the sanctity of the contract preserved.

If the principle is violated, it can cause major disruptions in the economy and result in the breakdown of not only investor confidence but in the credibility of the policy action of the government for the future. The regulator can do a revision of tariff only on established prices. These prices should be benchmarked with market dynamics and applicable only for future contracts. All the contracts are commercial in nature and review of tariffs cannot be possible retrospectively.

It is well-established fact that for wider benefits for the economy and environment, investors are incentivized to offset the opportunity cost through policy interventions. Government all over the world provides preferential tariffs for these sectors taking into the environment factors into consideration as is happening in sectors like the electricity vehicle and waste to energy projects.

However, in this case, it is the opposite and rather an effort to challenge the sanctity of existing contracts by the state government. To minimize such instances in future, make the sector attractive, and raise the ease of business parameter, the power ministry has promulgated creation of Electricity Contract Enforcement Authority (ECEA) to ensure that conditions in PPAs are followed, through the draft amendments to the Electricity Act 2003. It is expected that ECEA will be a single point agency of such arbitration and help in maintaining the sanctity of contracts through mutual discussions and negotiations for betterment of the industry.

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