New wine – old bottles?

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The Government of India has good reason to be bullish about the success of its first two 4,000MW 'ultra-mega' power projects. Both projects received attractive bids, with the winners of the Sasan project offering the remarkably low price of US cents 2.7/kWh.

Furthermore, Globeleq's participation in the Sasan project (the Sasan project along with all other development projects are believed to be excluded from Globeleq's current sale of operational power assets) suggests that foreign power companies, which left India in droves after the collapse of Enron's Dabhol project, are now willing to consider investing in Indian power projects again.

There is considerable confidence among Indian power companies that the problem plaguing Indian power projects in the 1990s – the lack of creditworthiness of most State Electricity Boards (SEBs) – is now well on the way to being solved. Ultra-mega power projects are connected to the national transmission grid and, thanks to the Electricity Act, 2003, they have access to the national transmission grid so they can seek creditworthy customers throughout India, instead of being held captive by a single SEB offtaker. This, in turn, has given the SEBs a strong incentive to improve their financial position so they can qualify to buy the attractively priced power that these large-scale power projects offer.

The Indian Government still needs to convince foreign power companies that they can rely on Indian contracts. Many of them have first-hand experience of the serial renegotiation of power purchase agreements (PPAs) that SEBs inflicted on them in the 1990s.

Unfortunately, the PPAs for the first two ultra-mega power projects seem to have been cobbled together from an old model PPA from the government's previous, discredited power policy.

Interstate trading requires unbundled contracts

Under the old model PPA, the SEB contracted with independent power producers in two distinct capacities: as the supplier of power to its customers and as the operator of the transmission network.

Wearing its supplier's hat, the SEB was concerned with how much power it was entitled to have delivered, the cost of the power, when the power would be available, and the damages and other remedies applicable in case of a failure to supply or take contracted power.

Wearing its transmission company hat, SEB was concerned with the location of the power plant and its proximity to the transmission system and facilities for delivering fuel and water to the site, as well as disposing of waste materials; the impact that the power plant would have on the environment; the existence of any transmission constraints preventing power from being wheeled from the power station to where it is required and the cost of reinforcing the transmission system to remove them; and the extent of the SEB's despatch rights over the power station to ensure that it will be operated in harmony with the other power plants connected to the SEB's transmission system. The old model PPA did not need to distinguish between the transmission and supply functions because they both fell within the responsibility of the SEB.

Now, transmission is steadily being unbundled from generation and supply to allow power to be traded across state lines. Suppliers that buy power across state lines are no longer responsible for where the power stations that generate their power are located – those power stations are now on someone else's transmission system in a different state.

In fact, there are a growing number of power purchasers that are pure traders and do not operate any power system. Yet the PPAs for Sasan and Mundra still make power purchasers responsible for the timely construction of the power plant's interconnection and for risks arising from the power station's location. In the new trading environment, these are issues that the generating company should deal with itself by agreement with the operator of the transmission system and (perhaps) with the State Government where the power station is to be located – not with its power purchaser.

The relationship between generating companies and power purchasers in India is changing, and PPAs need to change as well. In a market where power is treated as a fungible commodity traded across state lines, a generating company cannot expect its customers to accept responsibility for how it builds and operates its power plants, any more than a textile manufacturer could expect its customers to take responsibility for problems arising in the seller's factory. Once both generating companies and power purchasers have come to grips with the way the electricity industry in India is being restructured, they will realize that thee changes offer significant advantages for both parties.

Trading makes it easier to deal with contract default

Under the old power program, if a SEB did not pay for the power it contracted to buy from a power plant connected to its transmission system, the generating company's options were very limited. It could threaten to shut down the plant or curtail its power output unless the SEB paid what it owed, but this would shut off the generating company's own revenues.

Alternatively, it could terminate the PPA and require the SEB to purchase the power plant. Neither option was very attractive, or very effective. If it was the generating company that defaulted, its project lenders would exercise step-in rights and be given a lengthy period to cure the outstanding defaults before the SEB would be allowed to terminate the PPA.

The new trading environment offers the generating company and its customers much better options for dealing with contract default. The generating company can suspend or terminate the defaulter's rights under its PPA and resell its power to someone else, while holding the defaulter liable for damages if the market value of the power has fallen below the price agreed in PPA. The customer too can look to the interstate power market to replace power that the generating company failed to deliver in breach of its PPA and use the market price as a benchmark for calculating the damages to which it is entitled. The parties are no longer constrained to think in terms of a default terminating the project and forcing the generating company's customers to buy the power station.

While the Sasan and Mundra PPAs do recognize that traditional termination and buyout remedies are impractical when a generating station is supplying multiple, unrelated offtakers, they still adopt the traditional approach of making it as difficult as possible to terminate a PPA, even in cases of flagrant breach. For example:
• Before an offtaker may resell any surplus contracted power, it must first offer it to all of the other offtakers buying from the same power station (a requirement that will make short-term sales very difficult to arrange);
• A defaulting offtaker is given three years to cure a payment default before its PPA can be terminated and the contracted capacity sold to someone else unless the generating company waives its right to damages from the defaulter;
• No single offtaker may terminate its obligations under its PPA for a generating company default unless at least 50% of the offtakers from the same power station, representing at least 65% of its contracted capacity, vote to terminate the PPA, and then the termination applies to all of the offtakers; and
• The generating company's lenders can prevent the offtakers from terminating their PPA and finding a replacement supply of power simply by notifying them that they intend to find a new operator for the power station.

These restrictions on termination are no longer justified when the parties to a PPA can find new suppliers and customers in the interstate power market. Restricting the parties' termination rights will simply perpetuate the problem of persistent SEB default that plagued the old PPAs. Nor is there any obvious justification for requiring the generating company's customers to exercise their right to terminate a PPA for a generating company default jointly. Their rights and obligations should be several, not joint. Collective purchasing arrangements tend to be anti-competitive and may impose horizontal restraints that will impede the development of the interstate power market.

Trading allows for more efficient market pricing

In a market, the price of power varies by time of day and season, according to the changes in supply and demand. Power that can be supplied when demand is high is more valuable – and should be able to command a higher price – than power that is available when demand is low. Power sold under long-term PPAs, however, has traditionally been sold at prices reflecting the cost of producing it rather than its value to the offtaker. Under these long-term contracts, power supplied in the middle of night when demand is low is priced the same as power supplied at times of peak demand.

When a generating station has only a single SEB as a customer, the PPA under which it supplies power addresses the mismatch between the cost of generating the power and its value to the SEB. The PPA gives the generating company a financial incentive to achieve the highest possible availability while also allowing the SEB to despatch the generating station so that it generates as little power as possible when its cost exceeds its value to the SEB. This strategy does not work when the offtaker cannot control how the power station is operated because the generating company is selling power to multiple buyers. When the generating company controls the operation of its own power station, it may be tempted to divert power that it has contracted to sell under a PPA to another buyer who is prepared to pay more if the contractual penalties for non-delivery are insufficient.

The Sasan and Mundra PPAs attempt to limit this threat bureaucratically by prohibiting the generating company from selling power to anyone other than the offtakers and giving the offtakers the right to audit the generating company to verify that it is not diverting power in breach of its contract. This seems a clumsy and intrusive way of dealing with the problem. Its inefficiency could prevent the generating company from taking advantage of arbitrage opportunities that are beneficial to all parties to the PPA.

Generating companies should be allowed to divert contracted power to provide reserve or other ancillary services if those services command a higher price, provided that the customer whose power is being diverted is made whole. The way to facilitate economically-efficient arbitrage is through the tariff; if a generating company wishes use of an offtaker's contracted capacity for some other purpose, it must buy that capacity back from the offtaker at its market value to the offtaker, which will normally be the cost to the offtaker of acquiring replacement capacity from another source.

Taking Indian PPAs to the next stage

The success of the Sasan and Mundra tenders, and the entrance of a foreign power company into India's power market after some years, bodes well for the ultra-mega power project initiative. However, the PPAs require more work. They need to embrace more fully the opportunities that the emerging power trading environment in India offers lest the ultra-mega power projects suffer the fate of earlier large-scale projects that used similar documentation and cast unwarranted doubt on India's power sector reforms.

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