

LEGAL AND REGULATORY ISSUES IN THE THERMAL ENERGY SECTOR

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Overview

- **Energy Sector: Status & Issues**
- **Electricity Sector: Investment & Regulatory Regime**
- **EPC Contracts**
- **Project Finance-Issues and Risks**

Energy Sector

- **Status-Energy sector**

- Backbone of any economy & low spending limit growth rate
- Thermal Energy-64.6% of the installed capacity is from thermal sources

- **Ideal Position**

- Available Capacities \propto Demand

- **Ground Reality**

- Huge demand – supply gaps
- Generation: 200,000 MW by 2012-Mission -“Power for All by 2012”
- Investments of Rs 400,000 to Rs 500,000 crores i.e. Annualized investments Rs 40,000 crores

Thermal Energy Sector

- **Challenges**

- Dominated by PSUs/Government: Virtual Monopoly & Single buyer of all power;
- Lack of commercial focus & accountability;
- Inability to attract funds to bridge Demand – Supply Gaps
- Regulatory regime needed change
- Improvement in Lignite mining technology
- Important for new generating stations to be located near the load centre or pithead- Economies of Scale
- Execution of medium to long term fuel supply agreements for imported fuels for commercial activity
- Environment Issues
- Global push for development of green technology-Modernization of existing thermal power stations.

Electricity Law

- **Legislative & Regulatory Regime**

- The Electricity Act, 2003 brought into force w.e.f. 10.06.2003.
- Comprehensive legislation: obviating need for individual States to enact their own reform laws.
- Repealed the Electricity Act, 1910, ES Act, 1948 & ERC Act, 1948.
- Regulations issued under the Act by CERC & SERCs.
- Policies & Guidelines issued by Government of India (GOI).
- Guidelines for determination of tariff through bidding process issued on 19.01.2005.
- Distribution Licensees obliged to procure through competitive bidding /ERC obliged to adopt “tariff” [*Section 63*]
- Tariff Policy issued on 06.01.2006: All future requirement of power by Distribution licensees to be procured “competitively” in terms of Para 5.1 [*Section 3*]

Electricity Law

- **Investment Regime**

- FDI up to 100%: Automatic route in all segments (*except atomic power*).
- Tax holidays: Ten-year tax holiday for generation, distribution, transmission & distribution of power.

- **Impact on Market Structure**

- Single buyer to Multi buyer
- Access, Choice & Competition
- Seeks to create an environment to promote investments.

Electricity Act, 2003: A Snapshot

FUNCTION

- Generation: de-licensed
- Transmission: licensed
- Distribution: licensed
- Trading: licensed

COMMERCIAL FOCUS

- Metering & Billing
- Rationalization of Tariffs
- Assessment
- Theft & Enforcement
- Special Courts

POLICY

- NEP & TP -GOI
- NEP - CEA (in accordance with NEP)
- NREP

REGULATION

- CERC & SERC
- Licensing
- Tariff
- Subsidy
- Access

CONSUMER ISSUES

- Right to receive supply
- Quality of supply/standards
- Consumer Forums /Ombudsman

MARKET

- Entry barriers removed
- Multiple Licensees
- Multi-buyer & Multi-Seller
- Trading & Open Access

APPELLATE TRIBUNAL

- Central Appellate body to hear appeals from orders passed by State & Central Electricity Regulatory Commissions

Generation: Options & Structures

- **Opportunities**

- Identify projects being promoted by Central and/or State Governments: UMPP/State Initiatives.
- Identify opportunities to step into existing projects: promoted by other developers who may be willing to exit.

- **Entry Options: Structures**

- Set up JV Cos. with experienced local partners.
- Incorporate Generating Companies to implement identified Project.
- CPPs: Company, Association & Co-operative Society

EPC Contracts

- **Turnkey EPC Contracts – Contractor to take full responsibility**
 - Responsibility of contractor for care and custody of works till handover.
- **Force Majeure**
 - Political force majeure
 - Non-political force majeure
 - Payments for force majeure
 - Mitigation of effects of force majeure events
 - Performance excused

EPC Contracts

- **Variations**
 - Clear detailing for owner requirements
 - Contractor proposals for increasing efficiency
- **Price Escalation Clauses**
 - Clear identification of instances
 - Limited instances
- **Extension of time**
 - Progress schedule/critical path
 - Clear identification of instances
 - Limited instances
 - Payment for extension of time

EPC Contracts

- **Liquidated Damages/Bonus**
 - Delay liquidated damages
 - Performance liquidated damages
 - Bonus
- **Quality**
 - Quality assurance program
 - Third party inspection
 - Access to manufacturing site
 - Shop/Floor Test

EPC Contracts

- **Defects Liability Period**
 - Adequate defects liability period
 - Extension of defects liability period
 - Cut off date for defects liability period
 - Latent defects
- **Warranty Pass – Through**
 - Sub-contractor warranties
 - Technology provider's indemnities

Project Financing-Issues and Risks

- Long term commitments of participants: Debt servicing period
- Allocation of risk to parties that can manage it
- Cash flow of the Project is critical: Market/Offtaker
- Risk varies from participant to participant and over time
- Projects seldom enjoy rating above sovereign rating

Project Financing-Issues and Risks

- **Construction Risks:**
 - Turnkey fixed price and fixed term contract
 - Performance Guarantees and Warranties
- **Operation Risk:**
 - O & M (Bonus, Penalties)
- **Payment Risk:**
 - Offtake Agreement/Third party sales
 - Payment security mechanism
- **Market Risk:**
 - Feasibility report/market study

Project Financing-Issues and Risks

- Sponsor equity support, non-disposal and cost over run undertakings
- Matching of contracts
 - Monitoring through financial ratios, Information rights
 - Insurance third party liability, business interruption
- Adherence to Project standards & specifications
- Good Industry Practices

Project Financing-Issues and Risks

- Step-in rights & substitution rights
- Assignability of Project contracts
- Direct and Consent Agreements
- Trust & Retention Account
- Standard waterfall
 - Tax
 - O&M
 - Working Capital Lenders
 - Project Finance Lenders
 - Reserve Account
 - Equity

Project Financing-Issues and Risks

- Change in law & Change in tax: Compensatory clauses
- Critical consents and approvals (EIA clearance; RBI/FIPB Approval): CPs
- Country risk: Sovereign Rating/adverse balance of payments etc.
- Force Majeure: Excuse & Payment
- Insurance: Commercial and Political Risk cover from ECAs
- Foreign governing laws for contracts

Project Financing-Issues and Risks

- **Shift of Negotiation Balance**
 - Towards Developer
- **Dilution of Lender's Discretion**
 - Insistence to place reasonability tests
- **Limited conditions precedent**
 - No-predefined time for grant of environmental clearances, change in land use requirements, regulatory approval, etc.

Project Financing-Issues and Risks

Relaxed Covenants

- Push Back on cross defaults
- Demand for deletion or cross acceleration

Time for Security Creation

- Security creation as a CP sought to be waived because of requirement of license or approval

Project Financing-Issues and Risks

- Debt Recovery Tribunals
- Notified Banks and Financial Institutions
- Application to Tribunal by banks upon default in debt (secured/unsecured)
- Order of Tribunal enforced through Recovery officer
 - Attachment and sale of movable or immovable property
 - Appointment of receiver for management of property
 - Arrest and detain the defendant
- Appeal to Appellate Tribunal (75% deposit)

Project Financing-Issues and Risks

- Provides for enforcement of security interest by notified banks and financial institutions without judicial process
- Enforcement upon:
 - Default in payment of Secured Debt;
 - Account is non-performing
- May enforce security interest after serving notice (sixty day):
 - Take possession of secured assets
 - Take over management of the business
 - Appoint manager for the secured assets
 - Transfer by way of lease, sale etc.

Project Financing-Issues and Risks

- **Presence of Foreign Lenders: Security Creation becomes difficult**
 - RBI's permission under FEMA required to create interest on immovable property and shares
 - RBI's permission required for sponsor to guarantee foreign loans
 - Need to identify exotic structures: Shortfall undertaking; Indemnity
 - Increases enforceability & regulatory risk

Project Financing-Issues and Risks

- **Benefit of SARFAESI not available**
- **DRT is not available as a forum**
- **Creating inter-creditor mechanism remains a challenge**
 - Domestic lenders should continue to enjoy their rights while foreign lenders do not get dis-advantaged
 - Such ICA not tested for enforceability
- **Different Governing Laws and Forums (DHABOL)**
 - Loan Agreement and Inter-Creditor Agreement: English Law
 - Security Documents: India Law
 - In a default, this creates multiple suits

Project Financing-Issues and Risks

- Cost of security creation continues to be high
- Process for security creation remains lengthy
 - Need for licensor's/lessor's permission
 - Permissions remain discretionary with no objective standards.

Thank you

