FDI set for Indian IPPs

Domestic Indian players have been keen to seize the Indian IPP opportunity but international investors have been less so. By **Cam Brockie**, partner, and **Alistair Dunstan**, associate, **McDermott Will & Emery**; and **Anand Desai**, managing partner, and **Ajay Shaw**, associate partner, **DSK Legal**.

In order for India to maintain a growth rate of around 8.5% pa, Prime Minister Manmohan Singh made the development of power infrastructure a top priority for the country after the re-election of the Congress Party in 2009. The Indian Government has proposed in the region of US$500bn for a broad range of infrastructure projects, and envisages a third of this figure being funded by the private sector. With this, the Ministry of Power is hoping to add in the region of 55GW of power capacity by 2012 from both conventional and renewable sources.

The push into power infrastructure is needed urgently. With a deficit of power generating capacity of around 15%, India struggles to provide electricity to its vast population on a constant and reliable basis. Energy is commonly cited as one of the major drivers of economic growth, and without an almost immediate surge in capacity, India's growth as an economic powerhouse could falter dramatically.

There lie, therefore, significant opportunities for the private sector both at a national and international level. But, while the domestic sector seems to be gobbling up the rewards, international investors seem less keen. This article analyses some common foreign investor concerns associated with the Indian market, before examining how the power landscape has radically altered over the past few years with an aim of significantly improving the investment climate for foreign players.

Reluctance of foreign investors

The need for private sector investment in power infrastructure is clearly there. However, India has seen relatively few foreign players readily putting forward finance for such projects.

The question remains: Is Indian power infrastructure such a great investment after all? There are a number of major issues that have historically made the sector a no-go zone for foreign investors.

The first issue is land acquisition, whose problems are commonly cited as one of the largest contributors to project delays. While in many countries the relevant land is acquired before the bidding process is initialised, although not alone in the world, the Indian Government will commonly sideline land acquisition in favour of getting a developer on board.

The subsequent delays that inevitably ensue are normally down to a dependence on state governments to obtain the land necessary for the relevant power project. Even when state authorities do eventually manage to get hold of the necessary land on grounds of "public purpose", forced sales are always open to legal challenges by the former owners over the "existence of public purpose" or "inadequacy of compensation".

This was highlighted by the ongoing legal dispute relating to land acquired for the Reliance Power 7,480MW gas-fired power project in 2004 under the State of Uttar Pradesh's emergency powers, purportedly for a "public purpose". In a country where about 70% of its vast 1.17bn population is still dependent on a rural lifestyle, this presents serious food-for-thought for any international financier with an eye on Indian power infrastructure.

To add to the problems associated with land acquisition and related disputes, it is well known that the Indian civil courts are extremely congested. Most commercial contracts provide for arbitration but the enforcement of the final award in certain instances can be a time-consuming process in view of the many challenges to the awards that are brought in Indian courts, causing considerable delays in their enforcement.

With higher risks normally come expectations of higher returns. International investors will seek a rate of return that is perceived as commensurate with the risks inherent in infrastructure investments in developing countries.

In India, the rate of return is fixed by the Central Electricity Regulatory Commission (CERC) for projects where

The Indian electricity **market has** experienced a radical **shake-up**

electricity generation/distribution is an inter-state issue, and this also serves as guidance to State Electricity Regulatory Commissions (SERCs) which will set tariffs at a state level. Prior to 2004, the rate of equity return for power projects was set at 16%. The CERC then lowered this to 14% for the tariff review period 2004–2009, which undoubtedly concerned many international investors.

However, these tariff figures mean nothing if the tariff is not actually paid or the delay in payment from state utilities, which in most cases are the purchasers of power, is enormous. The financial health of some state utilities is questionable, with some facing near bankruptcy.

With the limited availability of other buyers, this presents a serious concern for project financiers. In addition, the current level of transmission and distribution losses, which range between 30% and 45% in many states, threatens the financial health of this sector. No meaningful development of the power sector would be feasible with these levels of losses.

Regulatory and approval issues will also inevitably be a key consideration for international financiers. The situation is exacerbated in India by the number of governmental institutions responsible for the electricity industry and electricity policy.

At a national level, the long list of bodies includes, inter alia, the Ministry of Power, the CERC, the Ministry of Petroleum and Natural Gas, the Ministry of Coal, the Ministry of Non-Conventional Energy Sources, and the Ministry of Environment and Forests (MoEF).

Inevitably, conflicts arise between the different agencies and this can lead to serious consequences for any power project. The issue should not be taken lightly, and the MoEF was pulled up for stalling various power projects through lack of clearances when the Prime Minister ordered a ministerial committee to review the pending projects in March this year.

While the issues highlighted above are by no means exhaustive, they represent a snapshot of the reasons behind the trepidation of many investors in Indian power infrastructure. But has the situation changed in recent years?

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Foreign investment right around the corner?

India is seen globally as a hot-spot for major investment opportunities. For example, UNCTAD's "World Investment Prospects Survey 2009–2011" lists India third after China and the US out of the top six destinations for foreign direct investment (FDI) from 2009 to 2011. However, as we have already discussed, there seems to be a general reluctance of foreign investors to put their money where their mouth is when it comes to power infrastructure.

Although, as with any developing nation, there are inherent risks that investors should be acutely aware of before investing in Indian power infrastructure, there are some real signs that the Indian power market has become substantially more investor-friendly during the last 10 years and, encouragingly, there have been strong indications of renewed foreign investor confidence in the sector.

During the past decade, the Indian electricity market has experienced a radical shake-up of its legislative framework and policy. By far the biggest contributor to this was the Electricity Act 2003, requiring inter alia the unbundling of state electricity boards into separate utilities for generation, transmission and distribution, open access to transmission networks, the de-licensing of power generation (and distribution in specified areas), in addition to the mandatory establishment of state regulatory bodies.

The Electricity Act has been further supplemented by the National Electricity Policy in 2005, and the Tariff Policy Resolution in 2006 (the Tariff Resolution). The Tariff Resolution makes it clear that the Indian government is keen to attract private investment, stating that it is "essential to attract adequate investments in the power sector by providing appropriate return on investment" and includes this as one of the Tariff Resolution's main objectives in addition to promoting "transparency, consistency and predictability in regulatory approaches across jurisdictions and minimise perceptions of regulatory risks".

Historically, India has placed limits on FDI in certain areas. As part of its liberalisation strategy and the reforms to the electricity market, 100% FDI under the automatic route (ie, without prior regulatory approval) was introduced in respect of power infrastructure, enabling any amount of equity investment to be poured into the sector.

While even the Indian power minister, Sushil Kumar Shinde, has admitted that the FDI liberalisation in respect of power has had relatively little effect so far, he has emphasised that the Indian Government is taking "many corrective steps to help the power sector grow, which is restoring confidence among foreign investors".

Significantly, the power minister made these remarks in May this year at the signing of a joint venture agreement between Singapore's Sembcorp Utilities and Gayatri Energy Ventures Private Limited, pumping Rs1,100 crore into a 1,320MW coal-fired power plant in Andhra Pradesh.

Leaving foreign equity investments aside for the time being, the power infrastructure sector has also faired pretty well under the Indian external commercial borrowings (ECB) restrictions. The Reserve Bank of India (RBI) recently eased ECB restrictions for infrastructure, permitting infrastructure finance companies to raise debt through ECB of up to 50% of their owned funds under the automatic route.

Furthermore, in July this year, the RBI announced a new scheme for ECB take-out financing for infrastructure proj-

Indian IPPs

ects, whereby borrowers in the Indian infrastructure sector would be permitted to refinance their domestic rupee loans with ECB. While this is likely to be of interest to foreign lenders preferring to put funds in post start-up due to completion risk, there remains the 100bp pa cap on commitment fees, which would need to be carefully considered.

The Land Acquisition (Amendment) Bill, 2010, currently pending before the Indian Parliament, attempts to address some of the land acquisition concerns harboured by many foreign investors. The Bill aims to resolve issues arising from land acquired by government for "public purposes" and seeks to include land acquired for infrastructure purposes under this umbrella. If the Bill is enacted, this will mark yet another step in the right direction to creating a more enhanced investment climate in the Indian power infrastructure arena.

Another initiative by the central government is the development of ultra mega power plants. UMPPs are plants with a minimum capacity of 4,000MW and each entail in the region of Rs15,000 crore of investment. In addition to using a competitive bidding process to boost investor confidence, the UMPP schemes progress land acquisition, provide fuel linkage, water, and obtain environmental clearances through the use of SPVs. These SPVs also facilitate power off-take and payment security, which would include revolving letters of credit and the use of escrow accounts.

The UMPPs have seen huge investments poured into them but the level of foreign involvement has been low, with most parties being domestic entities. However, the hope is that the success of domestic players will install confidence in foreign players. Significantly, the UMPP security mechanisms permit direct supply to other distributors in the event of a default, which would ensure a back-up cashflow.

Encouragingly, the rate of return looks like it's on the increase. Under the CERC (Terms and Conditions of Tariff) Regulations, 2009, the CERC increased its allowed rate of return for the tariff period 2009–2014 to 15.5%, with an additional 0.5% if the project is completed within a certain timeframe.

While the market will have to wait to see if investors are willing to invest at such a rate of return, a few projects are now structuring their promoter equity in the form of compulsory convertible preference shares (CCPS), permitting a fixed income for a set period before equity conversion.

There is now also less concern about the financial viability of state utilities as steps are being taken to improve their condition, including the implementation of the Restructured Accelerated Power Development and Reforms Programme (R-APDRP), which is aimed at bringing about both a technological and commercial revival of India's distribution system.

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In the past, investors have addressed payment risk by insisting not only on guarantees from the state governments, but also on counter-guarantees from the central government. In any event, thanks to the improved regulatory regime and other circumstances, payment risk has become less of an issue than it once was.

India is also keen to accelerate its nuclear power generating capabilities and has entered into co-operation agreements with countries including the US, the UK, Russia, France and Canada. However, foreign participation in this sector has not been forthcoming in the absence of an explicit legal framework for dealing with civil nuclear liability.

The approval of the Civil Liability for Nuclear Damage Bill by both houses of the Indian Parliament, which sets out the legal framework dealing with liability issues, will pave the way for foreign participation, particularly in the form of supply of equipment/technology in this sector.

Renewable Power – A recent drive in attracting foreign investment can be seen through the Indian Government's push for renewable power and the official introduction of the Jawaharlal Nehru National Solar Mission in January this year. The Solar Mission's target, which even the Indian Government labels as "ambitious", is 20,000MW of solar power by 2022. Through the Solar Mission, the Indian Government introduces a number of incentives that may be attractive to foreign investors, including:

- Generation Based Incentives of Rs18.44 per kWh (US$0.40) for PV projects, and Rs13.45 per kWh (US$0.29) for CSP projects;
- The CERC has stated that power purchase agreements concluded with solar power generators should be for a period of 25 years; and
- A concession with respect to customs duty, and the exemption of excise duty for specific components and equipment.

The CERC has also emphasised that such solar projects are entitled to the 10-year tax breaks that have been made available to other conventional power generating projects.

Under the National Tariff Policy 2006, SERCs are required to fix and purchase a certain percentage of power from renewable sources. The Solar Mission seeks to modify this to include solar power at incremental percentages to 3% by 2022.

The SERCs' renewable obligation would work in conjunction with a Renewable Energy Certificates (REC) scheme, which has recently been implemented and operates in a similar fashion to the UK and US systems, allowing distribution companies to meet their renewables obligations by presenting a certain amount of RECs.

The REC scheme provides an additional source of revenue to renewable power generators, permitting them to sell electricity at preferential tariff rates set by the

The government **is considering an** infrastructure debt **fund**

SERCs, or sell the power separately to independent entities along with the relevant RECs.

In September 2009, the CERC issued new tariff guidelines in respect of renewable energy generation, which include a pre-tax rate of return of 19% for the first 10 years of the project and 24% for subsequent years. This is significantly higher than that set by the CERC for conventional power projects, and will undoubtedly be welcomed by foreign investors investing in these projects.

Recent foreign investment activity – A recent show of strength by foreign investors can be illustrated by Asian Genco Pte Ltd (AGPL). Having started life in 2007, AGPL has invested in controlling stakes in a number of hydro, thermal and wind projects in Sikkim, Himachal Pradesh, Andhra Pradesh and Gujarat. In early 2010, a consortium of major foreign infrastructure players comprising Morgan Stanley Infrastructure Partners, Goldman Sachs, General Atlantic, Everstone Capital and Northwest Venture Partners invested about US$425m in AGPL.

Another route foreign financiers have been using to fund Indian infrastructure is the use of infrastructure investment/debt funds. The Indian Government is considering the formation of an infrastructure debt fund, whereby the fund would purchase debt from domestic banks in respect of projects having already reached completion.

Not only will this help the domestic banking sector, which is fast approaching lending capacities and has a reluctance towards long-term debt, but it will allow foreign investors injecting funds to diversify their risk into a portfolio of projects that have already entered commercial operation. In addition, any payments due would be backed by governmental guarantee.

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The Macquarie-SBI infrastructure fund is a recent example of the use of an investment fund. In 2009, Macquarie Group Ltd and the State Bank of India launched the Macquarie-SBI Infrastructure Fund with an aim to investing in the region of US$2bn–$3bn directly into Indian infrastructure.

Again, the fund would allow foreign investors to spread their equity investment risk in a large infrastructure portfolio. There are, of course, many other signs of foreign investment taking place in power infrastructure – take, for example China Light Power's investment into the Jhajjar thermal power project using the CCPS route outlined above – the message is clear: foreign investors are returning to Indian power infrastructure.

Conclusion

So what does the future hold for Indian power infrastructure? Is foreign investment right around the corner? Arguably, yes, it is. While many foreign investors do have reason to be sceptical of the investment prospects in Indian power infrastructure, the Indian electricity market and investment climate have evolved in such a way over the past few years that makes Indian power projects more and more attractive.

The drive by the Indian Government with respect to renewable power generation has been significant, attracting a considerable amount of investor interest, and while we do not envisage international players entering the conventional Indian power infrastructure market in their droves, the investment climate has improved such that it would be unwise not to give the market a second look.

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