Note on Return on Equity towards installation of FGD for Section 63 Projects

1. The Draft Order dated 03.07.2024 in 4/SM/2024 proposes to set the Return on Equity (RoE) at the same rate as the interest on debt. The justification provided is that compensation for the change in law should not be a mechanism to enhance the financial position of generating companies. This approach by the Ld. CERC appears to be based on the incorrect assumption that developers can secure equity capital at the same cost as debt. Such an assumption is fundamentally flawed. If RoE is set equal to the cost of debt, generating companies will incur significant losses due to the following reasons:

    a. Financing large-scale projects through internal accruals is unfeasible. Thermal generating companies with PPAs awarded under Section 63 are already grappling with financial challenges due to various uncontrollable factors and are barely sustaining their operations. These companies struggle to generate surplus funds due to rising interest rates and inflation in operation and maintenance expenses. Consequently, they incur significant losses in fixed costs and must rely on equity investors for funding Flue Gas Desulphurization (FGD) capital expenditures, who expect returns based on market conditions. Currently, the 1-year, 3-year, and 5-year Compound Annual Growth Rates (CAGR) for the Nifty 50 index are 26.61%, 16.64%, and 17.6%, respectively. Therefore, securing equity at the cost of debt is unrealistic.

    b. When a change in law event necessitates capital expenditure, power generating units typically raise additional capital to fund it. Relying solely on debt to finance this capex would be difficult as sufficient debt service coverage will not be available if the capital cost recovery is limited to only the cost of debt.

    c. Additionally, the return on equity needs to be higher than the cost of equity to attract investments in a capital-intensive sector like thermal power, which is highly exposed to policy risks and other inherent uncertainties.

    d. Currently, coal-based power generation plants are struggling to secure financing for any new capital expenditures. Lenders and investors are increasingly aware of the climate impact of coal-based plants, leading to higher financing costs for this sector. Consequently, equity investors are now expecting returns of around 18% per annum.

2. In the Draft Order, CERC has noted that it is not mandatory for bidders to adhere to debt-equity norms for competitively bid projects, nor is there a requirement to disclose debt-equity ratios. Consequently, CERC has not considered separate servicing of equity for the installation of FGD under Section 63 projects.

   This assumption by the Ld. CERC is incorrect. Compensation for any Change in Law, including the installation of FGD, must be based on actual costs and for ensuring this, developers under Section 63 PPAs can be required to provide the actual capital cost and details of funding. It is a settled position of law that compensation for a change in law is based on actual costs to restore the affected party to the same economic position as if the change in law had not occurred. This principle of restitution has been recognized by the Hon'ble Supreme Court in the Energy Watchdog case.

   Under these circumstances, if equity is not compensated at least at the normative rate of 15.5%, generating companies would not be restored to their original economic position as provided under the PPA and would incur financial losses, let alone earn any return on equity.

3. It is important to highlight to the Ld. CERC that, for granting relief/compensation under change in law towards energy charges for projects awarded under Section 63, this Commission, as well as many other State Electricity Regulatory Commissions (SERCs), have been considering normative operational parameters as specified under the Tariff Regulations. For instance, the Ld. CERC has allowed compensation for domestic coal shortfall by considering normative parameters such as Station Heat Rate and Auxiliary Consumption. The Hon'ble Supreme Court has upheld the consideration of these normative parameters.

   In a similar vein, financial norms such as the normative return on equity of 15.5% specified in the Tariff Regulations should be considered for approving change in law compensation for the installation of FGD in projects awarded under Section 63. This approach ensures consistency and fairness in the application of compensation principles.

4. The Return on Equity (RoE) allowed by the Ld. CERC as per the CERC (Terms and Conditions for Determination of Tariff) Regulations, 2024, is 15.5% on a post-tax basis for capital expenditures in thermal generating stations. This rate is deemed reasonable for attracting investments in the power sector. However, even this RoE is inadequate for FGD capital

expenditures, considering the cost of capital and the inherent risks associated with setting up capital-intensive and long-term investments.

5. For projects awarded under Section 62, the CERC (Terms and Conditions for Determination of Tariff) Regulations, 2024, provide for grossing up the base Return on Equity with the effective tax rate for additional capitalization related to emission control systems. However, this grossing-up of the base return on equity is not allowed for the installation of FGD in projects awarded under Section 63. This discrepancy needs to be reviewed to ensure equitable treatment across different project categories.

Request: The return on equity should be considered at least 15.5% towards installation of FGD for Section 63 projects along with tax gross up to restitute the thermal power generators.