

APP Comments on Draft CERC order on Compensation for Capex related to Emission Control System (ECS)

A. Background:

Central Electricity Regulatory Commission (CERC) had earlier issued a mechanism vide order in 6/SM/2021 on August 13, 2021 to determine the compensation for recovery of the expenditure incurred by the generating companies on account of installation of Emission Control System (ECS) in compliance with the revised emission standards issued by the Ministry of Environment, Forest & Climate Change (MOEF&CC), Government of India for the electricity supplied from Coal or Lignite based Thermal Generating stations. This mechanism is applicable to those stations (i) that have valid power purchase agreements (PPA) with the procurer(s) on the basis of the tariff based competitive bidding carried out under section 63 of the Electricity Act, 2003 as on date of issue of revised emission standards by MoEF&CC and (ii) where the notification of the revised emission standards is admissible as change in law event in terms of the respective PPA(s).

Recently, CERC revised the tariff mechanism of the ECS under the Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2024 based on the experience of the generating companies and after consultation with the stakeholders. Since these Tariff Regulations are not applicable to the projects covered under Section 63 of the Act, CERC is of the view that the existing compensation mechanism in its order dated August 13, 2021, in Petition No. 6/SM/2024, applicable to tariff based competitive bidding projects needs to be revisited. **Accordingly, CERC has proposed a revised mechanism through draft order dated 3rd July 2024 (Petition No. 4/SM/2024)** in order to elicit feedback and suggestions from the concerned generating companies, procurers, and other stakeholders. **In this draft order, four aspects have been revisited – (i) Recovery of Depreciation, (ii) O&M expenses, (iii) Cost of debt and equity, and (iv) interim relief in the form of provisional tariff.**

B. Positive aspects of CERC's Draft Order

We thank CERC for considering the requests made by APP and the industry for providing parity in the treatment of recovery of depreciation and O&M expenses between section 62 and section 63 PPAs. As per the changes proposed by CERC in the draft order, the treatment of recovery of depreciation and O&M norms will now be uniform across section 62 and section 63 PPAs. Further, allowing the filing of petition for interim supplementary tariff shall help to meet the debt service obligations and working capital requirements till the determination of the supplementary tariff by the Commission.

C. Remaining concern with the Draft Order

Treatment of Cost of Debt & Equity of ECS - Compensation under change in law is not governed by principles of tariff determination

The draft order continues with differential treatment between Sec-62 and Section 63 projects with regard to treatment of cost of debt & equity of ECS. For Section 62 PPAs governed by the CERC Tariff Regulations 2024-29, the servicing of debt and equity is treated separately for installation of ECS. **The Tariff Regulation allows interest on debt at actuals and Return on Equity for existing plants at 1-year SBI MCLR + 350 basis points (subject to the ceiling of 14%) with grossing up for tax.**

However, for **competitively bid projects under section 63, CERC has stipulated the cost of capital method wherein the return on capital cost shall be based on Net Fixed Asset (“NFA”) approach and has allowed the return at 1-year SBI MCLR + 250 basis points on declining NFA, irrespective of the actual cost of capital.** Due to this proposed change, generators under Section 63 PPAs would get lower and diminishing return on equity (6-7% lower on per annum basis – pls refer Annexure-I) in comparison with generators with Section 62 PPAs for the same ECS equipment installation.

CERC has justified this separate treatment by saying that there is no mandatory requirement for the bidder to follow debt - equity norms for competitively bid projects as per para 5.11 of the Tariff Policy 2016. Further, under Tariff based competitive bidding guidelines and the power purchase agreement issued by the Ministry of Power, the bidders are not required to disclose their financing arrangements at the time of bidding. Therefore, CERC is of the view that the principle of cost of capital employed is consistent with the Tariff Policy as well as the basic premises of the competitively bid projects.

However, it must be noted here that the framework outlined in Para 5.11 of the Tariff Policy 2016 deals with the determination of tariff by the Central Commission. On the other hand, the installation of ECS pursuant to the MoEF&CC notification issued subsequent to bid submission has been acknowledged as a change in law event under the PPAs by CERC and Ministry of Power. **Therefore, the cost of ECS has to be compensated under the change in law provisions of the PPA.** It may be recalled that the Hon’ble Supreme Court in the Energy Watchdog judgement dated 11.04.2017 held that – “*...the PPA read with these documents provides in clause 13.2 that while determining the consequences of change in law, parties shall have due regard to the principle that the purpose of compensating the party affected by such change in law is to restore, through monthly tariff payments, the affected party to the economic position as if such change in law has not occurred.*’ (bold supplied for emphasis).”

The above makes it very clear that the exercise of determining compensation to the generators for the change in law event of ECS implementation does not fall under the principles of tariff determination as outlined in Para 5.11 of the Tariff Policy 2016. **Instead, CERC has to ensure that the affected party (generating company) has to be restored to the same economic position as if such change in law has not occurred.** For this purpose, CERC would be well within its rights to direct the generating companies to disclose the actual debt and equity mix for financing of the capex at this point. **Therefore, there is no need to distinguish or discriminate Section 63 projects with section 62 projects for the reason as mentioned by CERC.**

Further, there is no rationale in not allowing the risk premium for the capital deployed for ECS. **Any capital infused by a Sec. 63 generating station after bid submission and pursuant to a statutory requirement has to be treated on the same lines as the capital cost of a Sec. 62 generating stations and the same principles as applicable for its determination of generation tariff shall apply to ECS established by Sec. 63 developer.**

Suggested Way Forward

As stated above, **the capital infused by a Sec. 63 generating station has to be treated on the same lines as provided to Sec. 62 generating stations.** Therefore, the servicing of debt and equity should be dealt with as provided under the CERC Tariff Regulations 2024-29 for Sec. 62 projects, which is:

- a. The equity capital may be capped to the extent of 30% and return on equity should be computed at the base rate of one-year marginal cost of lending rate (MCLR) of the State Bank of India plus 350 basis points as on 1st April of the year, subject to a ceiling of 14%, and the base rate of return on equity should be grossed up with the effective tax rate of the respective financial year.**
- b. Rate of interest on the loan for installation of ECS shall be the weighted average rate of interest of the actual loan portfolio of the ECS, and in the absence of the actual loan portfolio, the weighted average rate of interest of the generating company as a whole shall be considered, subject to a ceiling of 14%.**

For determining the above, CERC may direct the generating companies under Sec. 63 to disclose the actual debt and equity mix for financing the ECS.

We feel that the above approach would be more justified and equitable than the cost of capital treatment which is not in line with the provisions for change in law as provided under the PPA and upheld by the Hon'ble Supreme Court.

Notwithstanding the above, if the cost of capital treatment is continued, then CERC must ensure that the final impact on Sec. 63 projects should be the same as Sec. 62 projects. As already highlighted by us above, the present treatment of return on capital cost of SBI MCLR + 250 b.p as per the Draft Order is significantly lower than the compensation being provided to Sec. 62 projects.

Further, it would not be out of place to mention that even if CERC provides full parity in treatment between existing Sec. 63 and Sec. 62 projects, the return on equity would be still lower than the normative equity return for capital expenditure – 15.5% grossed up with the effective tax rate.

Annexure – 1

COMPARISON OF CAPITAL RECOVERY FOR FGD

Assumptions	Unit	Sec 62	Draft Order Sec 63
Capex	Rs Cr	1000	
Equity	%	30%	
Debt	%	70%	
Actual Interest Rate	%	10.50%	
Return on Equity	%	12.15%	NA
Cost of Capital	%	NA	11.15%
Grossing up of RoE		Yes	No
Depreciation Rate	%	5.28%	5.25%
Tax Rate	%	34.94%	

Note:

1. Sec 62 RoE = 1 Yr SBI MCLR + 350 bps
2. Sec 63 Draft Order: Return on NFA = 1 Yr SBI MCLR + 250 bps

in INRCrs

Financial Year				1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Section 62 PPA																			
Depreciation				53	53	53	53	53	53	53	53	53	53	53	53	20	20	20	20
Return of Equity				56	56	56	56	56	56	56	56	56	56	56	56	56	56	56	56
Interest on Debt				74	68	62	57	51	46	40	35	29	24	18	13	7	5	3	1
Capital Cost related Charges				182	177	171	166	160	155	149	144	138	132	127	121	83	81	79	77
NPV of Capital Cost Related Charge @ 12%			1,048																
Draft CERC Order for Sec 63																			
Depreciation				53	53	53	53	53	53	53	53	53	53	53	53	18	18	18	18
Cost of Capital Employed				112	106	100	94	88	82	76	71	65	59	53	47	41	39	37	35
Capital Cost related Charges				164	158	152	146	141	135	129	123	117	111	105	100	59	57	55	53
NPV of Capital Cost Related Charge @ 12%			908																
Difference - Draft CERC Order (Sec 63)/Sec 62				-18	-19	-19	-19	-20	-20	-20	-20	-21	-21	-21	-22	-24	-24	-24	-24
Impact on RoE				-6%	-6%	-6%	-6%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-8%	-8%	-8%	-8%