



Comments on CERC Draft Regulations on T&Cs for Tariff

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CERC's Proposed Approach to Calculate Return on Equity

- Ensure sufficient cash flow to meet debt repayment obligations
 - Loan repayment over first 15 years
 - For first 15 years, depreciation = annual loan repayment
- After 15 years, net assets will consist of equity only and equal to 30% of initial investment
 - Straight line depreciation until end of useful life (total 25 years)
- Annual return on equity for the entire useful life of the plant is 15.5% of the initial investment
 - This is the Gross Fixed Assets (GFA) approach because the initial investment is not reduced by accumulated depreciation
- We recommend that return should be based on net equity = initial equity less cumulative depreciation of equity component. This is the Net Fixed Assets (NFA) approach.

1. These comments reflect the individual views of the authors. CSEP does not hold an institutional view on any subject.

2. To reduce complexity, the discussion focuses mostly on thermal plants. However, the arguments and recommendations apply, in principle, to hydro plants also.

Reasons for Recommending NFA Approach

- Conceptually correct approach
- Two components of return:
 - Return “of” investment through depreciation
 - Return “on” should be only on the amount not yet returned.
 - Therefore, return should be on remaining equity only (net equity not gross equity)
- Depreciation accounting and calculation of return should be consistent.
 - Requiring consumers to pay return on gross equity allows generator to earn a return on the same amount twice.
 - Effective RoE will increase from the stipulated level of 15.5%.
 - GFA unfair to consumers.
 - Equivalent to taking loan from bank, making regular payments to return principal, yet required to pay interest on the total initial amount borrowed.

CERC Reasons for Proposing GFA Approach

- GFA provides internal resources for capacity replacement or addition.
- Recent spikes in prices at power exchanges signal shortage of power
 - ➔ investment in power sector needs a boost
 - ➔ GFA increases investor confidence

Response to CERC's Reasons for Proposing GFA

- Regarding requirement for GFA to provide internal resources for capacity replacement or addition
 - Amounts deposited in depreciation account, even if not getting return from customers, are invested by plant owner and earn a return
 - FoR report on factors affecting retail tariff suggests current RoE may be too high
 - RoE of generation companies needs to be made more realistic and at par with interest rates.
- No shortage of new power plants coming up (National Electricity Plan 2022-32)
 - 27 GW of thermal and 11 GW of large hydro already under construction.
 - In addition, 31 GW of thermal and 9 GW of large hydro in pipeline and expected to be commissioned during 2022-32

Recommendations

- GFA approach should be replaced by NFA approach
 - NFA is the conceptually correct and fair approach
 - Power plant owners can, and do, invest funds in the depreciation account resulting in amounts that can fund replacement capacity and additional capacity that may be needed.
 - Existing return of 15.5% may itself be considered high for power plants with the level of associated risk.
 - There are sufficient incentives for new power plants as seen by the new plants in the pipeline.
- If CERC still thinks a higher return than 15.5% is required, it should provide that in the regulations in a transparent manner.
- On the issue of GFA vs NFA, CERC should decide on the merits of the case and not rely solely on the view of stakeholders which are likely to be influenced by their respective expected benefits.

Thank you