THE CHANGING FACE OF PPPs IN INDIA IN LIGHT OF THE RECENT CERC ORDER GRANTING COMPENSATORY RELIEF TO ADANI AND TATA

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ABSTRACT

Infrastructural contracts between the government and the private sector are much like a double sided swordform the point of view of the government. On its one side lies the need to attain efficient output from the private Concessionaire by keeping the inherent monopolistic tendencies of such contracts at bay while on the other side lays the necessity to prevent frustration/termination of contracts as that would lead to greater hardships to the public. The services generated under such infrastructure contracts are of utmost importance and frustration of any such contract would result in wastage of resources as the project cannot be ever completely abandoned due to its high social utility and will require duplication of initial investment to restart the process. Therefore, governments more often than not try to mitigate such circumstances for as long as possible.

However, due to the immense public importance of the service or good in question, an extent of regulation by the government is seen as necessary even by the staunchest of the market capitalists though the aim of such regulation should be merely to ensure fair application of market forces to arrive at the most efficient solution to the infrastructure conundrum. This article is a modest attempt on part of the authors to throw light on the changing face of the Public Private Partnership in India keeping a focus on the two recent CERC orders that granted compensatory relief to TATA and Adani.

> *"The most predictable reality of infrastructure projects is that in a 30 year cycle, unpredictable happen."*[1]

I. INTORDUCTION

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[1] "Unravelling truth behind renegotiation of contracts." - Moneycontrol.com. http://www.moneycontrol.com/news/economy/unravelling-truth-behind-renegotiationcontracts_852398-0.html?utm_source=ref_article (accessed 13th November, 2014).

Infrastructural contracts between the government and the private sector are much like a double sided swordform the point of view of the government. On its one side lies the need to attain efficient output from the private Concessionaire by keeping the inherent monopolistic tendencies of such contracts[2] at bay while on the other side lays the necessity to prevent frustration/termination of contracts as that would lead to greater hardships to the public.[3]

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Initially, the monopolistic operator often does not focus on cost reduction, as it is prone to the 'quiet life' and associated X-inefficiency.[4] In order to cure such inefficiencies, most governments (including the Indian government) developed the process of competitive bidding to procure such contracts.

Through a moderately regulated process, the government attempts to stimulate the nearest possible market condition through competitive bidding. As far back as 1968, Demetz argued that the Government should auction the right to provide infrastructure services, believing that rivalry of the open marketplace (the invisible hand) disciplines more effectively than the regulatory processes of the government agencies (the visible clenched fist).[5]

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[2]Moszoro, Marian. "IESE, Business School."Opportunism in Public-Private Project Financing. http://www.iese.edu/research/pdfs/DI-0887-E.pdf (accessed 13th November, 2014).

[3]*Ibid.*

[4]Marques ,Rui Cunha , and Sanford Berg. "REVISITING THE STRENGTHS AND LIMITATIONS OF REGULATORY CONTRACTS IN INFRASTRUCTURE INDUSTRIES." Warrington. http://warrington.ufl.edu/centers/purc/purcdocs/papers/0914_Marques_Revisiting_the_Strengths.pdf (accessed 13th November 2014).

[5]Demsetz, H. (1968a). Why regulate utilities? Journal of Law and Economics. Vol. 11, no. 1, pp. 55-65

In India, the reasons for regulating competitive bidding, specifically in reference to the power sector, were emphasized and elaborated upon in the case of *Essar Power Limited v. UPERC and Anr.* (Appeal No. 82 of 2011). The scheme of regulations by the Central Government for competitive bidding was explained to be for the following purpose:

> *"a) To promote competitive procurement of electricity by the distirbution licensees;*
>
> *b) To facilitate transperancy and fairness in procurement processes;*
>
> *c) To facilitate reduction of information asymmetries for various bidders;*
>
> *d) To protect consumer interests by facilitating competitive conditions in procurement of electricity;*
>
> *e) To enhance standardization and reduce ambiguity for materialisation of projects;*
>
> *f) To provide flexibility to suppliers on internal operations while ensuring certainity on availibility of powe and tariffs for buyers."*[6]

As is unambiguously clear from the above explanation, the Supreme Court of India envisaged a situation where the government regulation was limited to the point of ensuring transparency and fairness. Beyond such point, the contract is to be managed as a commercial contract.

Post negotiation and partial execution, alteration of the terms of the contracts are possibleeither through renegotiation.

"Renegotiation refers to changes in the contractual provisions, otherwise than through an adjustment mechanism provided for in the contract"[7]In most commercial contracts, renegotiation is the most common method as it preserves the sanctity of party autonomy.Renegotiation of contract is a concept aptly researched on and contemplated in the international contract

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[6]*Essar Power Limited v. UPERC and Anr.* (Appeal No. 82 of 2011)

[7] Public-Private Partnerships, reference guide 1.0, PPIAF, World Bank. http://wbi.worldbank.org/wbi/data/wbi/wbicms/files/drupalacquia/wbi/wbippiafpppreferenceguidev11.0.pdf

jurisprudence. Yet, its scope and viability in long term infrastructural contracts is a highly debatable bone of contention for the academia as well as parties to such contracts. Especially in light of the fact that long term infrastructure contracts are executed with the intention of leveling tariffs for long periods of time, in most cases extending toa minimum period of 20-25 years.[8]The critics of any changes in the terms and conditions of infrastructure contracts contest that such alteration would result in prospectively modifying the tariff thereby nullifying the advantage of selecting the lowest bid through a competitive bidding process.

If the argument is extended, the disadvantage continues to be the same even if the terms are modified or tariff amended through intervention of independent bodies like the CERC(Central Electricity Regulatory Commission).

However, in the commercial world as transient and evolving as ours, the idea of stagnating the terms to the ones negotiated three decades prior to execution seem an impossibly optimistic, over-reaching ambition. Therefore, alteration of terms, conditions or costs being unavoidable, the questions that need to be answered is -In which cases is altering tariff or renegotiation or compensation of the adversely affected party efficient, commercially necessary and justified?

The above dilemma arose before the CERC in two separate cases and the judgment thereby could be considered either as a breather for private players in the infrastructure development or a flawed precedent that would cost the Indian government heavily in the future.

The important assumption to the present discussion is that the unexpected event resulting in the request for change is not contemplated for in the contract as falling under “force majeure” or “change in law” or any sub categories therein. These are those categories of unpredictable events that have been contemplated and the risk arising thereof allocated to either of the two parties thereby settling any potential future dispute with respect to the same.

The facts, reasoning and judgment of the two cases have summarily been discussed in the following sections.

II. IN THE MATTER OF ADANIPOWER LIMITED:

[8]Parashar, Kriti ." Challenges Faced By Power Purchase Agreement." Manupatra. http://www.manupatrafast.com/articles/PopOpenArticle.aspx?ID=1babeb18-e33d-419e-85fe-b7e20a5a557e&txtsearch=Subject:%20Power%20And%20Energy (accessed 13th November, 2014).

II.1 Facts:

The facts of the case relevant to the present discussion can be summarily explained as follows-

Two PPAs were executed between Gujarat Urja Vikas Nigam Limited along with two Haryana Utilities and Adani Power Limited under which power was to be supplied to these state utilities by Adani. According to the arrangements provided, Adani Power was responsible for fuel arrangements. In its bid the company provided a price for fuel procurement which was arrived at through two separate Memorandum of Understandings that it had entered into with Indonesian entities. Adani Power limited had majority shareholding in the said entities. The coal was procured at very low prices compared to its international market counterpart. This strategic inexpensive procurement of coal greatly added to the competitive terms of bid offered by Adani Power Limited. This was further exploited by the company by including it in "non-escalable" section thereby discharging any liability of the government in case of a price variation in future.

A 2010 Regulation of the Government of Indonesia stipulated that holders of mining permits in Indonesia will be permitted to sell coal only at benchmark prices accepted in the international markets. This impacted in raising the cost of procuring fuel so high that the project became unviable if operated at the prices agreed in the PPA. Adani Power approached the CERC for adequate relief.[9]

II.2 Order and Reasoning:

The main issues that arose for consideration was whether the promulgation and coming into effect of Indonesian Regulations and non-availability of domestic coal linkage had resulted in a situation where the project of the petitioner had become commercially unviable, making it impossible for the petitioner to supply power to the respondents at the tariff agreed in the PPAs.

The Commission perused various data presented by both parties and adjudged that the Regulation had altered the premise on which the energy charges were quoted by the petitioner in the bids submitted to GUVNL and Haryana Utilities.

Having so established, the burden/costarising out of the unpredictable event had to be allocated to either of the two parties. The Petitioners argued that since they had no control over the Regulation nor could have avoided it, the same falls within the ambit of "*Force Majeure*" as

[9]"INDIAN CORPORATE LAW: CERC Order in the Adani Power Case." INDIAN CORPORATE LAW. http://indiacorplaw.blogspot.in/2013/04/cerc-order-in-adani-power-case.html (accessed 13th November, 2014).

contemplated under Article 12.3 and also qualified as "Change in Laws" under Article ___ of the PPA. The "*Force Majeure*" argument was rejected on the ground that the Article specifically excluded change in prices from within its ambit. Also, it was abundantly clear from the discourse on the Article on "*Change in Laws*" that the intention of the parties was to refer to any such future changes in the laws of the country governing the contract i.e. India. Therefore, even this particular argument was rejected.

However, the Commission decided that it was within its power to award compensatory relief under Article 79 without its origin being tied to the Concessions Agreement. An important contention which the respondents raised and which the minority judgment took into account when refuting the prayer for relief by the Petitioners was that while presenting the bid, participating companies had an option to include various costs in the escalable or non-escalable heads. The Petitioners voluntarily placed energy costs as entirely non escalable with the intention to provide low bid price. In doing so, the Respondent argued and the dissenting judge agreed that the Petitioner had undertaken the risk of any future escalation in energy costs. The majority of the judges, however, considered that the merely including energy costs in non-escalable category need not exonerate the Respondents of all responsibilities in case of an unprecedented sharp rise in prices, especially considering that the bid was made in light of the then existing MOUs that the Petitioner had with two Indonesian Companies to supply the coal at prices quoted in the bid.

However, the Commission unanimously ruled that the present Indonesian Regulation neither falls in the ambit of "*force majeure*" or "*Change of Laws*" as contemplated under the PPAs.

The majority considered its regulatory powers under Article 79 of the Electricity Act plenary and awarded compensatory tariff to the Petitioners which was to be calculated by a Panel established by the Commission.

In its reasoning, it elaborated that:

> *"The common threads running along the length and breadth of the statutory scheme under the Act and the statutory instruments framed thereunder are the protection of the consumers' interest and ensuring adequate return on the investments in the sector. The consumers' interest is protected not only by fixing competitive tariff but it is equally imperative to ensure continuous, uninterrupted and reliable supply of electricity. ... Therefore, in the final analysis, the recovery*

of costs of the investors serves the consumers' interest by attracting investments in the sector by improving quality of supply of electricity to the consumers. Thus, twin objectives of protection of consumers' interest and recovery of cost of services provided are complementary. All the authorities established under the Act, have to strive towards achieving these objectives. This Commission as the apex regulatory body for power sector has the additional responsibility for meeting the objectives of law."[10]

CERC granted compensatory tariff to Adani Power by relying upon "its statutory responsibility to balance the interest of the consumers with the interest of the project developers while regulating the tariff of the generating companies". It further suggested that the two parties undertake consultative discussions to arrive at the quantitative estimation.

The Panel while evaluating such compensation ensured balancing off the excess income accrued by the coal exporting company due to the Regulation. This was done to ensure to achieve equity considering the coal exporting company was majority owned by Adani Power Limited.

In his dissenting opinion, Shri S. Jayaram noted the need to maintain the sanctity of the bidding process and prevent future situation of moral hazards on behalf of bidders who might indulge in precarious and deliberatelyunviable lower bids with the sole purpose of winning the project only to later claim compensatory tariffs.[11]

III. IN THE MATTER OF COASTAL GUJARAT POWER LIMITED:

"Tata Power had emerged as the L1 bidder for the MundraUMPP (4000MW) by quoting a levelised tariff of Rs2.26/kWh for the supply of 3800MW to various state DISCOMs. The project was envisaged to be operated on imported coal for which the company also purchased a 30% stake in an Indonesian mining company. However, due to unanticipated change in the Indonesian law in September, 2011, the increase in the cost of coal was far greater than assumed at the time of bidding which threatened the project viability. Consequently, the company filed a

[10]*Adani Power Limited, Ahmedabad Petitioner v. Uttar Haryana BijliVitaran Nigam Ltd. and others*, CERC Order in Petition No: 155/MP/2012**,** para 82, p.85

[11]*Adani Power Limited, Ahmedabad Petitioner v. Uttar Haryana Bijli Vitaran Nigam Ltd. and others*, Minority Judgment in Petition No: 155/MP/2012.

tariff increase petition before the CERC."[12]

The reasoning of the order was in sync with the one in the Adani order. The majority held that though the Indonesian Regulation did not fall within the ambit of either "*Force Majeure"* or "*Change of Law",* the petitioners were awarded compensatory tariff by the Commission by enforcing its plenary powers of tariff regulation under Article 79 of the Electricity Act. The compensation calculated excluded from its ambit any profits earned by TATA through its Indonesian coal export unit.[13]

IV. MODIFIED MODEL PPAs ISSUED BY THE GOVERNMENT OF INDIA

While considering both of the above applications, the Commission considered the amendment proposed by the Ministry of Power in the PPAs for competitive bidding. It is an attempt by the government to provide a breather to the fuel starved power projects of India.[14]The amendment touted as the "peaking power policy" provides for an annual revision of the base fixed charge to absorb a Wholesale Price Index fluctuation of upto 20% and pass through components of variable charge.[15]

The summary of the model Power Purchase Agreement provides that fuel charges are pass through and thereby transferring any potential future risk in price on to the government. Insuring the Concessionaire from all future fluctuation in fuel prices in corollary mean that it shall have no right over any profits/benefits arising out of a reduction in the fuel prices.[16]

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[12] http://www.careratings.com/upload/NewsFiles/SplAnalysis/CARE%20Research-%20Power%20Sector%20-%20Compensatory%20Tariff%20Orders%20-%20A%20Fine%20Balancing%20Act%20by%20CERC.pdf

[13]Committtee Report for CERC for calculation of Compensatory Tariff in the matter of Coastal Gujarat Power Limited.

[14]Indian Power Market, "Peaking power policy may provide relief to discoms" http://www.indianpowermarket.com/2014/02/peaking-power-policy-may-provide-relief.html (accessed 13th November 2014).

[15]"Peaking power policy may provide for up to 5-year contracts." livemint. http://www.livemint.com/Industry/fgzZD6TFFtAQXj0mruVwjK/Peaking-power-policy-may-provide-for-up-to-5year-contracts.html (accessed 17th November, 2014).

[16]*Coastal Gujarat Power Limited v. Gujarat Urja Vikas Nigam Limited, Vadodara and others*, CERC order in Petition No. 159/MP/2012, p. 61.

The Commission while arriving at its conclusion aimed to address the issue in accordance with the latest and evolving legal point of view on the matter instead of employing a method postulated six years ago.[17]

The previous PPAs, entered into by and enforceable against both Adani Power Limited and Tata Private Limited, provides that the Concessionaire is to be held responsible to operate for the entirety of the project duration at the estimated fuel costs projected at the time of making the bid. It ignores to take into account the volatility of the market conditions and the possible hardship arising out of the same.

Accepting that the proposed amendment was at the initial stage of deliberation and would be enacted prospectively only, the Commission took into consideration the same only from the point of view of understanding the evolving understanding of the subject.

V. CONCLUSION

The recent quagmire over PPPs executed in the past decade or two is not a phenomenon restricted only to the power sector. Most of these contracts were entered into at a time when the Indian Economy was a robust 9% and liquidity was a comfortable state of being for most companies.[18] There seemed no better time and no venue more profitable than the infrastructure sector to invest in. A slew of private public partnership projects were bid on in that period and most of such bids were based on estimations that were optimistic and with little anchoring in the realities of risk projections. Unsurprisingly, many of such Concessionaires are lining up in front of the government seeking relief with the finances robust no more.[19]

Be it the 1.5 lakh crore bailout requested by road developers or compensatory tariff prayers of TATA and Adani to the CERC, the sad truth remains that risk mitigation calculations were poorly made by the otherwise world class companies and yet they remain unscathed in an economy where everyone else is flailing. In criminal law, wilful negligence is a matter of serious delinquency and one that is, at times, even equated to intended crimes. To wager that the fuel

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[17]*Ibid.*

[18]Inamdar, Nikhil. "The mega road bailout - Rewarding corporate greed?." *Business Standard October 1, 2013. http://www.business-standard.com/article/economy-policy/the-mega-road-bailout-rewarding-corporate-greed-113100100151_1.html* (accessed 13th November, 2014*)*

[19]*Ibid.*

prices will not fluctuate over a period of three decades is neither optimism nor business prudence but a form of aggressive bidding with no thought of implementing the same without future changes in the Agreement terms or dole outs. Yet the bids were shortlisted and granted the projects. Adhering to the terms of such bids (transformed into Concession Agreements) has now been declared unviable by the CERC. The inviolable privity of contracts issue aside[20], would the private companies allow such interference had the situation been the other way round – the private companies had earned a profit many folds higher than that agreed upon and projected in the bid?

Inability of one organ of the government to enforce its contracts in front of another is a great loss in the credibility of these agencies. The threat was recognized by the then Finance Secretary, Gujaral who believed that "v*arying the payment schedule at this stage implies departure from a legally binding contract, an action that cannot be supported*[21]. This statement was made in reference to the road bail outs but its applicability to the CERC orders is undeniable.

Yet, a relief is granted and a precedent established. Let the pandora's box of bail out requests and compensatory reliefs be opened wide because the government would rather forgive, forget and ensure a road is constructed or electricity available rather than an avenged ego, a terminated contracts and much more of the tax payer's money wasted in starting the process again. The Concessionaires are aware of it and so is the government, public and the judiciary. While the first can exploit it at latter stages, the government can ensure that it would not be so cornered in future by incorporating safeguards at the initial stages itself.

Perhaps a lesson could not be adequately taught to the Private sector from the present incident but there is definitely one that can be learnt by the government. There are certain necessary changes that when made in the Concessions Agreement or the bidding process would provide for an accurate and smooth allocation of resources as well as better execution of contracts.
Socializing private losses due to their direct linkage to "too big to fail" projects has harmful moral hazard implications that the United States learnt a bitter way in the 2008 economic crisis

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[20]Bose, Pratim. "CERC order may open a Pandora's box." *The Hindu* (Kolkata), February 24, 2014, sec. Business Line. http://www.thehindubusinessline.com/news/cerc-order-may-open-a-pandoras-box/article5723088.ece (accessed 13th November, 2014).
[21]*Supra* n.18

and one that India should attempt to steer away from. The problem with the CERC order is not that it attempted to save power projects which had become unviable and likely to fail if not for its intervention. The problem rests with the lenient phrasing of the order which provides little scope for a different interpretation of the same in future disputes. The order does not condemn the private companies. In fact it touts them a victim of "unforeseeable and unexpected" changes. The reality being that the Indonesian Regulation has merely ensured that the minimum International prices are established and maintained. Even post the Regulation, the prices of coal in the Indonesian market is lower than that offered world over. To claim that such Multinational Companies with a talented hoard of professionals failed to contemplate that price of an exhaustible, non-renewable resource like coal would rise over a period of thirty years is a failure on behalf of the company.[22]

It is a failure on behalf of the government as well. It wrongly assumed that a PPP is a means to pass on a bundle such non-diversifiable risks to the private company.[23]More often than not, the companies are willing to agree to such terms with the assumption that future renegotiations would correct the discrepant distribution of risks in its favour. The CERC order restored its faith in the gamble while the careful players were the only ones who lost.[24]

The modified Model PPA is a humble acceptance on part of the government of a possible private public partnership where the risk allocation is driven by the economic rule which provides that risk should be allocated in a way that the party which can best prevent, foresee and bear the burden should be made responsible for the costs arising out of such a risk.

The fear amongst the critics and the cynics is that the CERC order coupled with such amendments to the model PPAs will create a market environment that would promote riskier behavior of investors and private parties. The order should have included a check to ensure that the renegotiations to follow would not result in the private companies arm-twisting the government due to the public interest served by their projects.

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[22]*Supra* n.1.
[23] "Urbanomics: Moral hazard from CERC ruling is a reflection of India's corporate culture". http://gulzar05.blogspot.com/2013/04/moral-hazard-from-cerc-ruling-is.html (accessed 13th November, 2014).
[24]*Ibid.*