

# India's UMPP Program: Attracting International Finance?

Fueled by an annual average economic growth of over 7 percent since 1997, India's electricity consumption is increasing rapidly. The Government of India has estimated that the country will have to add 90,000MW of generation capacity over the next five years in order to keep up with demand. It plans to meet these energy requirements through the development of Ultra Mega Power Projects (UMPPs), coal-fired power plants with generating capacity of 4,000MW, each costing approximately US\$3.75 billion.

**Ultra Mega Power Project (UMPP)** – A term used by the government of India in reference to super critical power plants with capacity of over 4,000MW. These projects are being promoted under India's eleventh 5-year plan. The program is administered by India's Power Finance Corporation, which undertakes initial project development (site identification, environmental clearances, coal block allotment/linkage, energy sales allocation) and transfers the project to the private sector under a tariff-based bidding system. To date, eight UMPPs are in various stages of planning and development.

**The Dabhol Power Project** – At \$2.9 billion, it was the world's largest independent power project. The project, sponsored by Enron, was underpinned by a PPA with the Maharashtra State Electricity Board (MSEB) for 90% of the plant's output, with both local and central government guarantees. Under the PPA, prices were pegged to the dollar and the offtaker carried the risk for currency fluctuations. The project was financed by a combination of domestic and international banks, as well as U.S. Export-Import Bank, with political risk insurance from the U.S. Overseas Private Investment Corporation. In 2001, the project went into arbitration when the state of Maharashtra stopped paying its bills and sought to cancel the PPA. By the time of settlement, the project had been the subject of nearly 30 arbitrations and lawsuits.

Although India's domestic banks are relatively liquid and capable of backing some domestic infrastructure projects, the scale of these investment requirements, combined with competing demands from other sectors, will prompt the country to look abroad for additional financing. This outward push, however, will be hampered by the negative impressions formed among foreign investors and lenders in the wake of the Indian power market failures in the 1990s – particularly the Dabhol Power Project, as well as most of the so-called "Fast Track" projects.

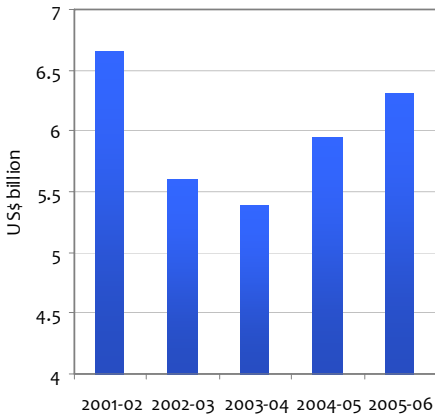
Some observers have argued that India has overcome the legacy of Dabhol, pointing to the successful financing, with foreign bank participation, of Tata's Mundra UMPP. The US\$4.375 billion project reached financial close in April 2008, achieving a debt-to-equity ratio of 75:25. The project debt is broken into dollar and rupee tranches of US\$1.825 billion and US\$1.46 billion, respectively, of which the dollar loans are sourced primarily from multilateral lenders. A single private foreign bank participated in the financing, and is 95 percent covered by Korea Export Insurance Corporation (KEIC).

## Key Risks of the Mundra UMPP

The project, for which Tata Power is providing 100% of the equity, is structured around 25-year take-or-pay power purchase agreements (PPAs) with seven Indian utilities and electricity boards. Many of the offtakers from the project suffer from poor credit; some have negative cash flows. Unlike the Dabhol contracts, the new PPA structure enables the Project to sell power onto the spot market in the event of default. With the development of a national electricity grid and the high demand for power, this arrangement should greatly mitigate the project's offtake risk. However, the PPA requires that the Project offer all other offtakers first priority to any additional power before it is able to sell power onto the spot market, hampering its ability to enter into short-term sales contracts. The UMPP is also forced to give the defaulting offtaker three years to pay its past dues before it may terminate the PPA.

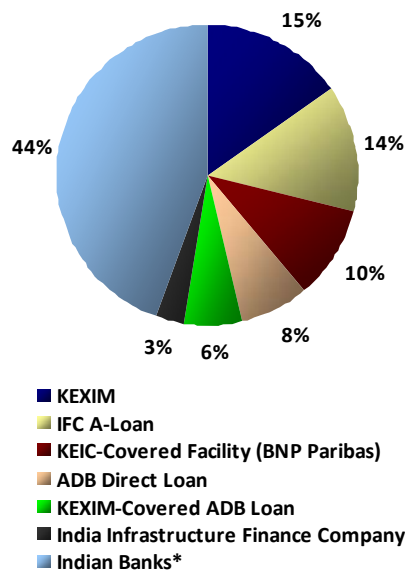
The second major risk associated with this project structure, as illuminated by the Dabhol experience, is that of currency risk. In the case of the Mundra UMPP, over half of the project's debt is dollar-denominated, while all of the revenues will be in rupees. Although this risk is naturally hedged during the construction period and the heavy use of domestic lenders may mitigate a portion of the currency risk, the plant will rely on foreign currency-denominated coal imports throughout its operational life. While a portion of the electricity tariff will be indexed to the foreign exchange rate, portions of the tariff are not even indexed to domestic inflation, leaving the Project vulnerable to exchange rate fluctuations.

### State Utilities' Losses on Electricity Sales



Source: Planning Commission, Government of India, Eleventh Five-Year Plan

### Mundra UMPP Financing Sources



Rupee-denominated

Source: Infrastructure Journal

#### DISCLAIMER

The information contained in this Commentary is of a general nature and is not intended to be used for investment advice. This Commentary has been prepared by Taylor-DeJongh from sources we believe to be reliable and accurate at the time of writing.

© 2008 Taylor-DeJongh

In light of these risks, some potential lenders – including JBIC – demanded a sovereign guarantee from the Indian Government and refused to participate in the financing when it was not provided. Similarly, Asian Development Bank (ADB) records indicate that KEXIM showed equal concern over the risks of the Mundra project. KEXIM involvement was predicated on a risk participation agreement with ADB, whereby it is covering a portion of ADB’s loans to the project, but mitigates its risk through ADB’s negotiating leverage in the event of default. KEXIM’s total involvement in the project consists of a US\$500 million direct loan plus its coverage for ADB’s US\$200 million loan. ADB is providing an additional US\$250 million loan, and KEIC is covering a US\$325 million facility provided by BNP Paribas.

### ECA Risk Mitigation

As the Mundra UMPP demonstrates, in spite of the risks associated with foreign exchange rates and counterparty creditworthiness, power projects in India are able to obtain financing, both on domestic and international markets – although that financing may not necessarily be from private-sector banks. Export credit agencies (ECA) and multilateral lending agencies can be critical to financings in emerging markets. Owing to their government shareholders, these types of institutions benefit from a certain degree of protection from political risk, as host country governments are thought to be less likely to default on loans from a politically-backed organization than on loans from private parties – both out of concern that the governments might step in and that other projects in the host country will no longer be able to access financing from ECAs and multilaterals.

With private banks already constrained in their lending, their willingness to take on Indian power risk will be greatly reduced and additional sources of financing would be required. For example, ECAs would provide not only risk mitigation but would act as an additional source of liquidity, as their funding is somewhat insulated from financial markets. ECAs have become increasingly adept at leveraging not only private sector funds, but also that of other multilateral institutions, as when ADB enabled KEXIM’s participation in the Mundra UMPP.

### Conclusion

Despite the positive signals sent by the financial close of the Mundra UMPP, there remain significant issues hindering the implementation of the national program. The lack of government guarantees despite poor counterparty credit and the remaining inflexibilities in the offtake contracts of the UMPPs remain significant barriers to attracting foreign financing. Given the tremendous capital investment requirements of even a single UMPP, which in the case of Tata directly resulted in a downgrade from BB+ to BB- by Standard & Poors, additional structuring and risk mitigation will be critical to making additional UMPPs bankable enough to attract more foreign capital.