August 16, 2020

Multiple MoUs signed with IPPs to reduce cost of power generation

Prime Minister, Imran Khan has disclosed that after negotiations between the government and Independent Power Producers (IPPs), an agreement has been reached, which will lead to reducing the cost of power generation. This will benefit the people in the days to come. *"In the coming days, we will improve power transmission system and bring in a reform package to reduce theft and line losses, which will result in lower electricity prices. We have the burden of debt and other expensive electricity, but with these agreements, I see an industrial Pakistan, where people can find employment,"* he said. Our Market Lens of today evaluates this issue in detail.

Govt renegotiating various power policies: Highlights of multiple MoUs signed over the weekend

The government and majority of IPPs established under Power Generation Policy, 1994 and Power Generation Policy, 2002 have signed settlement pacts, paving the way for reduction in power tariff and future circular debt. In addition, the government and WPPs have signed an MoU to increase term of power plants by five years against certain relief in key items of the tariff. However, pacts with coal fired power plants set up under Power Generation Policy, 2015 and RLNG plants have yet to be signed. The terms of MoU are subject to approval of Federal Cabinet and IPPs' Board of Directors & other necessary corporate approvals. Any revision in agreements related to RLNG and coal-fired power plants established under CPEC are being discussed with the Chinese top leadership. Key takeaways from the said MoU are:-

IPPs installed under Power Generation Policy 1994

- *The existing capacity payments and variable O&M shall be reduced by 11%;*
- *USD exchange rate and US CPI indexations shall be discontinued on 50% of the reduced capacity payment, which shall be fixed at National Bank of Pakistan's TT/OD selling PKR/USD exchange rate prevailing as on August 12, 2020 without any local or international currency indexation or inflation adjustment for the future;*
- *In lieu of the tariff reductions herein above, any heat rate sharing by any IPP as per its existing arrangement shall cease to exist;*
- *USD exchange rate and US CPI indexations on reduced variable O&M and 50% of the reduced capacity payment shall continue as per existing arrangement;*
- *The parties shall look into the possibility of termination of plants considering their' commercial and technical viability;*
- *The Government of Pakistan intends to create competitive power markets. Without prejudice to the terms of its generation license, the IPP shall actively support and participate in the Competitive Trading Arrangement when it is implemented and becomes fully operational;*
- *The parties recognize that payment of the receivables of the IPPs is an integral part of this MoU as key consideration. The Power Purchaser and GOP shall devise a mechanism for payment of the outstanding receivables within agreed time period which shall be reflected in the final agreement to be signed;*
- *The power purchaser shall ensure adherence to its contractual obligations, and GOP and power purchaser shall work towards resolution of the Expert's adjudication for the relevant IPPs;*
- *Once Federal Cabinet and Board of Directors of the IPP approve the terms of this MoU, the Committee and IPPs shall agree and document details and procedures of these understandings, along with IPPs' project specific issues, preferably within 30 days, after which the same shall be submitted to relevant counterparties, to be followed by legal documentation to amend the tariffs and relevant agreements and;*
- *This MoU is valid for six months from the date hereof and shall stand terminated on signing of the detailed agreements;*

IPPs installed under Power Generation Policy 2002

- *For oil fired projects, any savings in fuel will be shared on a sliding scale starting from 70:30 in favor of the Power Purchaser for the first 0.5% efficiency improvement above currently NEPRA determined benchmark efficiency, followed by 60:40 for next 0.5%, followed by 50:50% for next 0.5%, and finally 40:60 for any efficiency above that. Power purchaser will not share in any efficiency losses;*
- *For oil fired projects, any savings in O&M will be shared 50:50 after accounting for any reserves created for major overhauling, to be reviewed by power purchaser or NEPRA as mutually agreed. If reserve for major overhaul remains unutilized, it will be shared in the ratio of 50:50 between power purchaser & IPP. Power purchaser will not share in O&M & major overhaul losses;*
- *For gas fired projects, the fuel and O&M will be taken as one consolidated line and any net savings will be shared 60:40 in favor of the Power Purchaser, after accounting for any reserves created, or to be created for major overhaul, to be reviewed by power purchaser or NEPRA as mutually agreed. If the reserve for major overhaul remains unutilized, it will be shared in the ratio of 60:40 between the power purchaser and the IPP. Power purchaser will not share in fuel, O&M and major overhaul losses;*
- *In order to ensure that the actual efficiency is matching the efficiency reported in the accounts, the GoP shall conduct a heat rate test for all projects for which the GoP and IPPs' representatives will agree on the TORs and corrections required;*
- *Late Payment Surcharge (LPS) will be lowered from currently KIBOR + 4.5% to KIBOR + 2.0% but it will be ensured that payments follow the PPA mandated FIFO payment principles for this rate to be effective. Compounding and interest on interest provided for in the PPA, etc. will be adjusted to match the settlement agreement initialed (but never put into effect) by GoP and some of IPPs in 2019;*
- *For foreign investors registered with SBP, the Return on Equity will be 12% prospectively. For local investors, the Return on Equity will be changed to 17% in PKR with no dollar indexation. In recalculating the return, the equity approved by NEPRA on COD in USD shall be converted into PKR at the exchange rate of Rs.145 for prospective calculation;*
- *On "miscalculation" of IRR on account of periodicity of payments, no adjustment shall be made for the past as the regulator had expressly allowed this in its decisions. For the future, NEPRA shall make the calculation of IRR on a monthly basis and shall consider on merit adjustments for costs denied in lieu thereof;*
- *All projects will convert their contracts to Take and Pay basis, when Competitive Trading Arrangement is implemented and becomes fully operational, as per the terms defined in the license of each IPP;*
- *In order to assess if a company has made any "excess profits", the reconciled financials between the Committee and the IPPs engaged in this exercise, shall be submitted to NEPRA. NEPRA shall decide in this matter and provide for a mechanism for recoveries where applicable;*
- *Payment of the receivables of the IPPs is an integral part of this settlement. The Power Purchaser & GOP will devise a mechanism for repayment of outstanding receivables with agreement on payment of receivables within an agreed time period which will be reflected in the final agreement to be signed and;*
- *Once NEPRA and Federal Cabinet approve the terms of this MoU, the parties shall agree and document details and procedures of these understandings within 15 days, after which the same shall be submitted to NEPRA and CPPA, to be followed by legal documentation to reflect the amendments needed in the relevant agreements;*

IPPs under CPEC	Government owned power plants/GENCOS
• *The Chinese authorities have indicated that they would also review the power purchase agreements (PPAs) of IPPs installed under CPEC umbrella keeping in view the rising circular debt adversely impacting the country's economy;* • *The coal-based Port Qasim Power Plant, Sahiwal Power Plant, Hubco Power Project, Hub Balochistan, Engro Thar and UEP wind power plant have been installed under CPEC and their agreements will be discussed with Chinese authorities to get concessions in agreements. The said projects were set up under the 2015 power policy with 15% rate of return plus the US dollar indexation;* • *Pakistan will engage the Chinese authorities on the government to government level for relief in the PPAs once the finalisation of the agreements with the IPPs established under various power policies are completed and signed;* • *Chinese President is visiting Pakistan next month --- the government is planning to use that visit to ask Chinese authorities to reduce dollar return to 13 per cent from existing over 17 per cent and extension in tenors of the IPP projects set-up under CPEC umbrella;*	• *The government has decided to reduce the profits of three Gencos: Jamshoro, Muzaffargarh and Guddu and other smaller government power plants from 15 and 16 percent to 10 percent;* • *The government will also reduce the rate of return of hydropower projects owned by Wapda to 10 percent;* • *The four RLNG-based power plants set up at Bulloki, Haveli Bahadur Shah, Bhikki and Trimmu will be privatised with a rate of return of 12 percent, not the 10 percent, just to incentivise the expected buyers and to this effect;* • *The return of government owned power plants will be converted into rupees;*

MoU between Govt. & Wind Power Producers (WPP)
• *The two sides "have agreed to alter their existing contractual arrangements to the extent of, and strictly with respect to, the matters listed under the MOU";* • *For some conditions to materialise, the government would have to change the Alternative & Renewable Energy Policy (AREP) 2020 approved earlier this month by the Council of Common Interests. Meanwhile, some other conditions are also subject to uncertainties;* • *The MoU terms are subject to an approval from the Federal Cabinet, the NEPRA and WPP's board of directors, shareholders, lenders and others. The MoU is valid for six months with effect from August 14 and shall stand terminated on signing of the detailed agreements;* • *The WPPs will coordinate with their lenders and make all efforts to extend the debt-tenor by five years, reduce the spread over Libor by 50-75 basis points and reduce the spread over Kibor by 100-125bps. Entire benefit from these changes shall be passed on to the power purchaser — the NTDC;* • *The government shall support the WPPs in replacing their current Kibor-based long-term domestic debt with the State Bank of Pakistan's refinancing facility for renewable projects;* • *The WPPs shall coordinate with their O&M operators and make all efforts to reduce their O&M costs by 20-25 per cent. They would also reduce their insurance during operations from existing arrangement to actual, subject to a cap of 0.7pc of EPC cost approved under the respective tariff;* • *For WPPs developed under the upfront tariff regime of 2015, tariff sharing will remain the same for net annual plant capacity factor (NAPF) till the NAPF approved in the respective lenders' technical advisor report (P90 level). For NAPF above the P90 level, the tariff shall be reduced to 50pc for the WPP;* • *In future, the return on equity (RoE) including RoE during construction shall be reduced to 13pc per annum. The miscalculation of internal rate of return, on account of periodicity of payments, has been addressed through this reduction in return component;* • *The committee shall recommend govt to explore possibility of allowing the existing WPPs to develop hybrid wind-solar projects at the existing wind farm sites;* • *The government committee acknowledged that getting relief from lenders and the O&M operator will require support from the government which shall be provided to the WPPs;* • *For WPPs where delayed payment rate (DPR) is set at Kibor plus 4.5pc in their existing contractual arrangements, the DPR in all future invoices shall be reduced to Kibor plus 2pc for the first 60 days after the due date, and thereafter at Kibor plus 4.5pc;* • *For all invoices the NTDC would ensure that payments including the DPR invoices follow the FIFO payment principle under the Energy Purchase Agreement;* • *Curtailment and payment of the receivables of the WPPs are integral consideration of the MOU. The mechanism for cessation or compensation of curtailment shall be devised by the WPPs, NTDC and government collectively whereas mechanism for outstanding receivables shall be devised by the NTDC and government, each of which shall be reflected in the final agreements with each WPP. The NTDC and government would have to ensure adherence to its contractual obligations;* • *Once Nepra, Federal Cabinet and WPPs Board of Directors, shareholders and lenders approve the terms of the MoU, the parties shall agree and document details and procedures of these understandings preferably within 30 days, after which the same shall be submitted to Nepra and the Central Power Purchasing Agreement (G), to be followed by legal documentation to reflect the amendments needed in the tariff and relevant agreements;*

Source: Various Newspaper Clippings, AHCML Research

Energy sector circular debt: The elephant in the room

- By June 2020, circular debt in the power sector stood at Rs2,219 billion foreseen to swell up to Rs4,000 billion in 2025. If the status-quo prevails in the power sector, power tariff in 2025 will surge by Rs5.1 per unit, driven mostly by Capacity Purchase Price;
- Circular debt is on the rise on account of inefficiencies in entities such as PSO, PLL, GENCOs, NTDC, CPPA, DISCOs in the power sector being run by government. The circular debt as of June 30, 2018 was at Rs1,153 billion which has increased by 100 percent to Rs2,219 billion as of June 2020;
- If DISCOs operations are not improved, inefficiencies will add a further Rs1.5 trillion to the circular debt by 2025, which could increase to Rs4 trillion. Meanwhile, capacity payments would be hovering in the range of Rs1,500 to 1,700 billion by 2025;
- We understand, any reduction in returns of power producers will reduce the need for a future tariff increase. However, gains in terms of tariff reduction are negligible, if any. For savings to reach a meaningful level, a similar exercise be repeated with government-owned projects and those falling under CPEC. Further, a meaningful tariff reduction requires that governance reforms must be extended to include energy distribution system;

The power sector pundit, however, has a different point to make

We had the opportunity to discuss these MoUs – prepared in light of the 'Report on the Power Sector, Committee for Power Sector, Audit, Circular Debt Resolution and Future Roadmap, March 2020' - with a power sector pundit. Key takeaways from that talk of ours are as follows:-

- *These are not final agreements; rather these are MoUs that are subject to approval of Federal Cabinet and IPPs' Board of Directors & other necessary corporate approvals. And still there is a long way to be covered prior to reaching final agreements with the government. So in effect much is fluid even now;*
- *IPPs want the government to first come up with a mechanism to pay their outstanding dues within the agreed timeframe prior to inking the final agreement;*
- *IPPs say their existing agreements with the government are based on take or pay mode and until Pakistan has a competitive market system having multi-buyers of electricity - being generated by IPPs - the agreements cannot turn into the ones based on take and pay mode;*
- *The criticism on the MoU signed with IPPs under 1994 Power Policy is that Capacity Payments for the remaining years is being reduced by 11%. This would not bring much gain for the Country as the capacity payment portion of tariff in the last 5 to 6 years is minimal. Most of the IPPs under 1994 Policy have taken capacity payment upfront in initial years. The MoU is thus giving special favour to 1994 Power Policy plants. Unless the MoU leads to reduction in tariff for all previous years also, it would not have much benefit for the government when it comes to 1994 Power Policy plants;*
- *Regarding the impact on IPPs under the 2002 Power Policy, the MoU will have significant negative impact on those IPPs' forward earning as they will not have the same level of indexation as earlier envisaged in their PPAs;*
- *The MoUs lead to no immediate financial relief to IPPs on both payment terms and resolution of liquidity issues stemming from energy sector circular debt;*
- *For the MoUs to translate into legally binding contracts it will take 6 months --- that is a 'time' --- so one must tread cautiously before forming an opinion on this matter;*

Source: AHCML Research

Impact on listed IPPs

Within the listed IPPs space, power producers set up under Power Policy, 2002 include Engro Powergen Qadirpur (EPQL), Nishat Power (NPL), Nishat Chunian Power (NCPL) and HUBC's Narowal Plant while HUBC (Main Plant) and KAPCO fall under Power Policy 1994.

While it will be too pre-mature to quantify the impact of the MoUs on IPPs' earnings, we understand that overall earnings growth and valuation contributions of IPPs – especially those under 2002 Power Policy - are anticipated to fall. We thus anticipate a 'bearish' tone for IPPs in future stemming from the recently signed MoUs.

Impact on Pakistan economy

The signing of these MoUs signals government's resolve to revise contracts with skewed investment incentive structure. It will also set the tone for adjusting certain other contractual arrangements for other energy sector projects.

We understand, the government has signed MoUs with seven IPPs established under the 1994 Power Policy and 12 IPPs set up under the 2002 Power Policy. The government wants to bring down the tariff and once the final agreements are signed with all IPPs and government projects, then the impact would be determined when it gets included in tariff order. However, the impact in the shape of relief to end consumers will be sizable - ~PKR450bn total relief estimated *(Annual sale of electricity: ~1bn units X Cumulative downward revision in average tariff: Rs 4.50/unit --- provided agreements with RLNG- and coal-fired plants are reviewed for which talks with top Chinese leadership are already in progress)*.

Overall, we can say once these MoUs turn into agreements - as per their spirit - they could lead to reduction in cost of power generation and hence bode favourably for both business and consumers thus auguring favourably for the Country's economy.

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