

BARRIERS TO FINANCING
INDIAN RENEWABLE ENERGY

RENEWABLE ENERGY PROJECTS
THE LEGAL PERSPECTIVE

Third Renewable and Distributed
Generation Task Force Meeting

San Diego, California
March 27, 2007

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- BARRIERS TO FINANCING INDIAN RENEWABLE ENERGY PROJECTS – LEGAL PERSPECTIVE

- ◆ Large power projects are difficult to finance in developing countries like india:

- ★ Smaller Renewable Power (Hydro And Wind) Have Been Much Easier To Finance Than Have Large Thermal (Gas-/Coal-fired) Power Projects – The So-called Mega/Super Mega Power Stations.

- ★ However, Larger Biofuels (Biodiesel/Fuel Ethanol) Projects Are Beginning To Be Financed At Sizes of 30 Million Annual Gallons to 100 Million Annual Gallons.

- ◆ Lack of contract sanctity has been a significant problem.

- ★ Dabhol Power Tarrifs.

- ★ Tamil Nadu Power Tarrifs.

- ◆ Failure of States To Uniformly Apply The 2003 Indian Electricity Act With Respect To Third-Party Sales.
- ◆ Long Term Tax Incentives / Low Customs Duties On Capital Equipment Are Required.
- ◆ Excessive Numbers of Permits, Clearances and Other Governmental Authorizations At the Central/Federal, State and Local Government Levels – Single Window Clearance/Pre-Vetted Projects Are A Must.
- ◆ Need To Stabilize India’s Tax Environment – Tax Regulations Change Frequently, With Tax Incentives Regularly Added and Dropped. Recently, The Government of India (GOI) Finance Ministry Eliminated The 100% Tax Exemption On Income Earned By Investors (“ROI”) and Lenders (Interest) For Investments And Loans Into Infrastructure Projects. The Removal Of This Important Incentive Will Increase The Costs of Developing Infrastructure Projects

- ◆ Heavy Regulation of Labor – Difficult to Scale Down Jobs During Economically –Depressed Times. Like The Power Sector, The Labor Sector Is Subject to “Concurrent Jurisdiction,” Meaning That the Central and State Governments Each May Adopt Regulations. This Approach Over-Complicates The Area.
 - ★ Difficult To Attract Contract Labor for Short-Term Projects.
 - ★ If More Than 100 Employees, Then One Needs Express Approval From The GOI Ministry Of Labor To Eliminate An Employee – Thus, One Must Structure A Company In Order To Give Persons -- “Officer And Other Titles”, So That They Are Not Held To Be Low-Level Employees.

- ◆ Requirement for No Objection Certified (“NOC”) From a previous JV partner where subsequent investment is in the same field – potential for abuse. While Press Note 1 (2005 Series) is an improvement over Press Note 18 (1998 Series), it still leaves uncertainty for foreign investors.
- ◆ Poor infrastructure acts as deterrent to foreign investment in the manufacturing sector. The GOI must privatize government–owned enterprises to attract substantial necessary foreign capital.

High Duties – Must lower duties on raw materials and imported goods. India continues to have the highest customs duty rates in Asia, if not the world. The 2007 Budget did lower the peak rate of basic duties for non-agricultural products from 12.5% to 10%, and the effective overall duty rates from 36.74% to 34.13%

- ◆ India's Court System (a Unitary Court System) is plagued by Intractable delays. Substantial backlog/delays in cases: If no new cases were filed, it would take approximately 350 years to clear the current court case backlog (not including administrative judicial and quasi-judicial case backlogs).
- ◆ Purchase Preference Policy – gives state and GOI-owned companies a 10% bid amount preference in government contracts.
- ◆ India only has 16 years' experience in opening markets. The regulatory environment is still evolving rapidly – expect change.

◆ RISK MITIGATION SECURITY MECHANISMS – AS LENDERS AND INVESTORS REQUIRE PROTECTION

- ★ Mitigate the risks associated with the SEBs through widespread SEB restructuring and improvement in the security and payment mechanisms in arrangements with the IPPs.
- ★ Irrevocable LOCs -- In a typical “PPA”, the generating company submits an invoice within an agreed timeframe. The invoice is generally payable through an irrevocable revolving letter of credit (“LOC”), issued by the concerned State SEB through its banks. However, in case of a default, the bank may simply refuse to renew the LOC, and the generating company may end up facing substantial risks.

- ◆ **ESCROW ACCOUNTS** -- An escrow arrangement is another mechanism to protect against the SEB credit risk. It is usually a complex arrangement, whereby an escrow agent is appointed for the specific project. The escrow agent establishes escrow accounts, an SEB account and a generating company account. Such agent also creates a charge and hypothecation over the SEB receivables. In the event of a default in payment, the escrow agent transfers an equal amount of receivables from the SEB escrow account to the generating company's account. It is advisable to retain some amount as security in the escrow account in order to provide effective security to the generating company. However, there are a number of difficulties involved in the escrow account security mechanism. One such problem is the simple failure of an SEB to fund the escrow account.

- ◆ HYPOTHECATION AGREEMENTS, STATE GUARANTEES, GOI COUNTERGUARANTEES -- In such case, a hypothecation agreement can be protective, as it would shift payments of power purchasers from the SEBs directly to the electricity generator. State Government guarantees and GOI counterquarantees also would assist secure the lenders and protect the investors by guaranteeing payments, if the LOC and Escrow Account mechanisms have failed.

- ◆ SEB REFORMS -- In the long run, reforms must concentrate on how the SEBs may collect more revenues through (i) more efficient collection mechanisms, (ii) power theft control, and (iii) market-linked tariff regimes, as well as through the privatization of the electricity distribution sector. Few SEBs of states, such as Orissa, Delhi, Haryana, Karnataka and Andhra Pradesh, have taken positive steps towards (i) unbundling power generation , transmission and distribution assets into new entries and (ii) corporatizing those entities with leadership less subject to political whims.

◆ PTC POWER PURCHASES

- ★ Innovative structures, wherein agencies such as the Government of India-owned (Power Trading Corporation (“PTC”)) are intermediate buyers of power, and effective offtake risk mitigation measures, also have enhanced the potential of new projects to achieve financial closure and better ensure success.
- ★ In a milestone in the evolution of India’s power sector, the Hyderabad-based Lanco Group’s 300 MW thermal power project in the State of Chhattisgarh became the first power company to achieve financial closure on the strength of a PPA with the PTC. All Indian private sector projects previously had secured financing from banks and financial institutions on the basis of executing sophisticated PPAs with SEBs.

- ★ The process of achieving Lanco's financial closure has accelerated following the creation of an inter-institutional group ("IIG") of lenders. The IIG consists of the IDBI Ltd, State Bank of India, ICICI Bank and Power Finance Corporation.
- ★ Dozens of projects have achieved financial closure in India, since the IIG was established in January 2004. Many of these projects, financially closing on "all – India finance" (i.e., no foreign lenders) basis, have reached such closings, only because project sponsors, unlike previously, have agreed to accept fuel and other project risks. International leaders and equity sponsors will not accept these fuel and project risks.

- ◆ CONTINUING INDIAN POWER FINANCE PROBLEMS
 - In sum, foreign investors and financiers require sanctity of contracts (including the purchase of, and full payment for, contracted power), honored-payouts for purchased power under binding guarantees (i.e., payment (i.e., counter guarantees) and debt (i.e., sovereign guarantees) security mechanisms), and the knowledge and practice that invoices will be paid in full and regularly without requiring litigation to ensure each payment.

■ PROTECTING YOUR INVESTMENT

- ◆ Engage qualified counsel, accountants and consultants at the outset.
- ◆ Need for Upfront & Well-Considered Tax and Corporate Structuring, using limited liability vehicles and Double Taxation Avoidance Treaties (U.S., Mauritius, Singapore, Cypress, UAE).
 - ★ Reduction of tax and non-tax liabilities through limited liability vehicles/firewalls.
 - ★ Use of bilateral investment treaties/agreements.
- ◆ Special Economic Zones (“SEZs”) have a 100% tax holiday and currently there are more than 237 SEZs with GOI approval, after the GOI lifted the 150 SEZ approval restriction.

- ◆ Project and Partner Due Diligence Are Key Exercises.
 - ★ Ensure that your partner is trustworthy and has the financial ability to implement the investment.
 - ★ Enshrine IP protection in all contracts.
- ◆ Contracts Require Certain Protective Clauses:
 - ★ Neutral-country arbitration is a must
 - e.g., London venue with ICC, UNCITRAL, London Court of International Arbitration Procedural Rules.
 - if pressed into arbitration in India, bifurcate the arbitration clause so that smaller disputes are arbitrated in India and larger ones are arbitrated in a neutral country.

- ★ A “forward waiver” provision requiring Indian joint venture partners to provide No Objection Certificates (“NOCs”) upon request of the U.S. partner to avoid future problems in entering into similar industry ventures with other parties. The foreign party in such circumstances must demonstrate that the new investment would not adversely impact the existing joint venture – Press Note No. 1 (2005 Series) versus Press Note 18 (1998 Series).
- ★ Strong Indemnification Clauses.

- ★ Force Majeure – this provision permits suspension of contractual obligations under certain circumstances.
- ★ Compliance with U.S. Foreign Corrupt Practices Act (FCPA) and Indian anti-bribery laws – accusations particularly can adversely affect public company stock.
- ★ Need for insurance requirements to protect transactions, such as political risk insurance against expropriation, arbitration award enforcement insurance, etc.

◆ Key Policy Areas to Address:

- ★ Provide long-term, stable government policy support.
- ★ Reduce technology and commodity risks.
- ★ Consider the use of venture capital and private equity, capital markets, and other funding mechanisms.
- ★ Establish a federal carbon credit market for the monetization of carbon credit offsets to create new project revenue/income streams.