Ambit Capital Pvt Ltd.

POWER SECTOR UPDATE

New Tariff Norms for Power Generation Companies

CERC, the central regulatory authority for the power sector has issued a new notification which deals with the tariff computation for the years 2009/10 to 2013/14.

We believe that this would be moderately positive for all the central utilities, including NTPC, Neyveli Lignite and Powergrid. We have a Buy recommendation on the stock with a target price of Rs217, and a further upward bias. We also understand that these regulations will not be applicable to Tata Power, Reliance Infrastructure or Torrent Power.

The key highlights are:

- Normative debt-equity ratio unchanged at 70:30.
- Return on Equity increased from 14% post-tax to 17.481% to 24.239% on a pre-tax basis. The key difference being the assured post-tax RoE to an assured pre-tax RoE. **We believe that this will incentivise more investments in this sector, as also boost returns of existing players.**

	Pre-tax	Pre-tax after gross-up
Existing Plants		
MAT rate	15.5%	17.481%
Full tax rate	15.5%	23.481%
New Plants*		
MAT rate	16.0%	18.044%
Full tax rate	16.0%	24.239%

** New plants wouldbe eligible for higher RoE only if they are commissioned after 1st April 2009 and within the time-limits specified in the guidelines*

- Depreciation rates enhanced to 5.28% on the main plant and equipment, but concept of Advance Against Depreciation (AAD) removed. AAD was introduced mainly to ensure that higher fixed costs are recovered in the earlier years so as to enable the project developer to repay the loans. This is now not required as the higher depreciation rate should enable the project developer to recover higher costs in the initial years. Futher, this rate of depreciation would be applicable for the first 12 years of the project. Thereafter, the balance gross fixed assets would have to be written off over the remaining life (13 years in case of coal / gas plants, and 23 years in case of hydro plants and transmission systems). We believe that this change has a neutral impact on the companies.
- Fixed Cost recovery would now be based on **85% plant availability factor** (PAF), as against the earlier 80% plant load factor (PLF). We believe that this would increase the profitability of more efficient players such as NTPC as their plant availability factors as high, especially as while PAF is in their control, PLF (or demand) is not within their control. Further, the risk of availability due to inadequate fuel is now to be borne by the project developer.
- Further, normative parameters for station heat rates have been tightened, but only for new plants. The maximum deviation from the manufacturers' specified heat rate allowed would be 5% in case of new gas-based power plants, 6.5% in case of coal-based plants, and 7.1% for liquid fuel-based plants. In the past, the station heat rate was an absolute value for all plants. For older plants the has been marginally reduced for 500MW and above sized plants.

Analyst

Mehul Mukati
Tel.: +91-22-3043 3211
mehulmukati@ambitcapital.com

- O&M expenses continue to be allowed on a normative basis, that is the absolute amount of O&M expenses is specified. However, unlike the previous regulations, the new regulations reduce the total expenses allowed depending on the number of units (economies of scale) at each location (plant).
- Thermal power plants now have two options with regard to renovation & modernisation. Either they can claim a special allowance on the basis of per MW per year after completion of normative useful life of the project & will be obligated to deliver the operational norms set. The other option is to avail a comprehensive R&M expense / reimbursement which is to be permitted by Commission on the basis of detailed cost benefit analysis including the efficiency gains to the beneficiaries.
- Interest on loan would be considered on the average of the normative loan outstanding. The maximum normative loan repayment allowed is equal to the depreciation benefit claimed.
- The Commission has also allowed the project developer to hedge its foreign exchange exposure, and the cost of such hedging would be a pass-through cost to the extent of the normative debt.

Other points of note:

- CDM benefits would now have to be shared by the project developer with the beneficiaries. In the first year, the project developer is allowed to retain all the benefits derived from any CDM project. From the second year, 10% of the benefits have to be shared, increasing by 10% in each of the subsequent years, upto 50%. Thus, from the sixth year onwards, the CDM benefits would be shared equally between the project developer and the beneficiaries.
- CERC has decided to separately bring out the tariff regulations for renewable energy based projects. This exercise has already been started and is likely to be completed within next six months.
- These regulations would be the guiding principles for the State Electricity Regulatory Commissions

We believe that Tata Power & Reliance Infrastructure would not immediately benefit from these new regulations as they are covered by the regulations of the Maharashtra Electricity Regulatory Commission (MERC). Having said that, we also believe that all the state electricity regulatory commissions would follow suit, and use these regulations are model guidelines. However, each state has a different time line, and that for Maharashtra is 2007/08 to 2009/10. Similarly, the benefits for Torrent Power would accrue later as the timeline followed in Gujarat is 2008/09 to 20010/11. However, it is possible that given the new regulations by CERC, the state commissions may follow sooner, rather than later.

The immediate beneficiaries would be NTPC, Neyveli Lignite and Powergrid in the listed space. We reiterate our buy recommendation on NTPC with a target price of Rs217, and a further upward bias.

Ambit Capital Pvt Ltd.

Ambit Capital Pvt. Ltd.
Ambit House, 3rd Floor
449, Senapati Bapat Marg, Lower Parel,
Mumbai 400 013, India.
Phone : +91-22-3043 3000
Fax : +91-22-3043 3100

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