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Working Paper

Power purchase agreements for risk and rent sharing in Himalayan hydropower developments

Queen's Economics Department Working Paper, No. 1203

Provided in Cooperation with:

Queen's University, Department of Economics (QED)

Suggested Citation: Jenkins, Glenn P.; Dhakal, D. N. S. (2008) : Power purchase agreements for risk and rent sharing in Himalayan hydropower developments, Queen's Economics Department Working Paper, No. 1203, Queen's University, Department of Economics, Kingston (Ontario)

This Version is available at:

<https://hdl.handle.net/10419/67796>

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**POWER PURCHASE AGREEMENTS FOR RISK AND
RENT SHARING IN HIMALAYIAN HYDROPOWER
DEVELOPMENTS**

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3-2008

POWER PURCHASE AGREEMENTS FOR RISK AND RENT SHARING IN HIMALAYIAN
HYDROPOWER DEVELOPMENTS

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MARCH 2008

POWER PURCHASE AGREEMENTS FOR RISK AND RENT SHARING IN HIMALAYIAN HYDROPOWER DEVELOPMENTS

ABSTRACT

The Himalayan Rivers have an enormous hydropower potential that is still not exploited fully for the benefit of the region. Bhutan and Nepal together have an economically feasible potential of 60,000 MW of hydroelectric power generation capacity but are too weak financially to bear alone the risks associated with the development of their hydro resources. India is the only potential market for the electricity supplied from these sources. The power purchase agreement framework for the 336 MW Chukha Hydel Project in Bhutan could serve as a model with regards to the transfer of risks, management of risks, and sourcing of finance in exchange for the sharing of the economic rents associated with such projects. India undertook the costs and risks of constructing the hydroelectric dam and power plant in exchange for a reduced purchase price of electricity from the completed facility. This paper contains a financial and economic assessment of the Chukha Hydel Project. While India is in a position to exercise monopsonic power in this electricity market, this analysis shows that it is possible to have an agreement for sharing of the risks and returns between India and the Himalayan countries that is highly beneficial to all the stakeholders.

Keywords: power purchase agreement, Himalayas, hydropower, electricity, Bhutan, India, electricity exports, risk sharing, economic rents

Jel Codes: H 43, Q42

POWER PURCHASE AGREEMENTS FOR RISK AND RENT SHARING IN HIMALAYIAN HYDROPOWER DEVELOPMENTS

INTRODUCTION

The Himalayan Rivers that flow south into Ganges and Brahmaputra plains have enormous untapped hydro-power potential. The estimated theoretical hydro-power potentials of these rivers in eastern and central Himalayas are: Bhutan, 30,000 MW; Nepal, 84,000 MW; Sikkim, 8,000 MW; and Arunachal Pradesh, 80,000 MW. The combined potential of the western Himalayan Indian states is 40,000 MW. So far only some 20,000 MW of hydropower generation capacity has been developed in all these rivers combined. An additional 20,000 MW of generation capacity is now under construction, mainly in the Indian Himalayan states. Nepal's developed hydropower generation capacity stands today at 550 MW (Gautum and Karki, 2005).

India's demand for electricity is growing rapidly and this growth in demand is almost certain to continue. In January 2008, the installed generation capacity of all types was 140,302 MW (Verma, M.S., 2008). The current rate of economic growth is rapidly increasing the demand for electrical energy. In 2007, India's average peak load capacity deficit was 12% of its installed capacity, with 10% energy deficit of the total energy generated (Roy, Ranjeev, Ranjan, 2008). To sustain the current trend in its economic growth rate, India will need to add another 100,000 MW of installed capacity by 2012. The Kirit Parikh Committee Report estimates India's requirement of power generation capacity at 778,000 MW by 2032 (Ahmad Talmiz, 2006).

Large hydropower project sites, particularly those with lower per MW investment cost, are now being examined for development. Investment opportunities in hydroelectric projects will increase with the growth of India's electricity demand as the real cost of alternative sources of energy increase. It has been estimated that India will require USD 200 billion in capital investment for expansion of electricity generation and transmission capacity over the next five years (Shahi, 2004). Potentially, a considerable portion of this investment could come to Bhutan and Nepal where low cost hydroelectric sites are relatively close to India's power grid.

India has recognized the need to build the necessary infrastructure for long distance electricity transmission in order to establish the inter-connectivity of its five electricity regions. The energy generation resources in India are not evenly distributed. Its vast reserves of coal are mainly located in

the eastern electricity region¹ while the bulk of the potential hydropower generation sites are located in the Himalayas which are closer to the northeastern, eastern and northern electricity regions. The national grid facilitates the development of the Himalayan hydroelectric resources as the long distance transmission infrastructure is largely in place to bring the electricity to market.

Bhutan and India have progressed in their collaborative hydropower development since the completion of the 336 MW Chukha Hydel Project in 1989. In 2008 prices, India invested 403.65 million in Chukha, 1,267 million in Tala, and 181 million in Kurichu hydroelectric projects to create a total installed capacity of 1410 MW in Bhutan. More recently India has signed a memorandum of understanding with Bhutan to develop an additional 5,000 MW of hydropower generating capacity by 2020. In contrast, Nepal has hesitated to enter into long-term power purchase agreements with India in the development of its vast hydropower resources fearing that India will exploit its monopsonic power in the negotiation and implementation of these projects.

While there is little doubt about the visible impacts of India's investment in hydropower projects in Bhutan, there has not been a rigorous analysis on how the financial and economic costs and benefits have been allocated between the two countries. India has invested the capital, built the projects on a turnkey basis, and agreed to purchase the surplus electricity supplies. The project agreement has allocated all the completion and market risks to India, while providing Bhutan with a stable stream of revenue in exchange for the hydro energy from its rivers.

Using the historical data on investment costs, operating costs, hydrological data and price adjustments for inflation and cost escalation, this study estimates the financial and economic costs and benefits from the perspective of both Bhutan and India.

The Chukha Hydel project is a run-of-the-river scheme located on the Wang Chu gorge in Western Bhutan². The physiography of the area permits the creation of a water head of 404 meters. The dam has a storage capacity to generate 336 MW of peak load for four hours daily throughout the year. From June through September the monsoon rains increase the water flow so that during this period the generation can be at a 336 MW level on a 24 hours a day basis. At other times of the year the facility is designed to utilize 336

¹ Coal reserves in India are estimated at 200 billion metric tones.

²In a run-of-the-river project, a dam is built across the river to divert water onto the turbines for generating base load only. If storage space is available upstream for construction of a dam, storage capacity could be built to store water for peak load generation every day in addition to the base load supply.

MW of capacity to meet the morning and evening peak load demand while using only 84 MW of its capacity to meet the base load demand during the off-peak hours. The contractual agreement does not differentiate between peak and off-peak energy. Instead, with regards to fixing the price of electricity export, it divides the total energy generation between firm and seasonal energy³.

The project was financed entirely by India. The investment included preliminary works, civil works, buildings, production equipment, special construction equipment, labor, construction materials, environmental protection works and transmission lines. Expressed in 2008 prices, the initial estimated cost in 1974 was USD 156.04 million. The project was completed at a cost of USD 403.65 million, including the cost of another tail race tunnel, which was not included in the initial estimate. The cost overrun was nearly 159% in real terms. Repeated cost revisions were the major concern of India. The successful completion of Chukha was crucial for its prestige and future cooperation on other major hydroelectric undertakings in Bhutan.

CONTRACTUAL ARRANGEMENT

The terms and conditions of the contractual agreement between the two countries are critical for the allocation of the benefits flowing to each of the parties from the projects. The salient features of the “Agreement between the Government of India and Royal Government of Bhutan regarding the Chukha Hydel Project” (CHP, 1974) are paraphrased below for consideration in the financial and economic analysis:

- (1) The project was to be managed by the Chukha Project Authority (CPA) until the time of its completion. After its completion, the CPA will hand over the management to the government of Bhutan.
- (2) India will provide the total investment on the project, 60% as grant and 40% as a loan to Bhutan. Bhutan is required to repay the loan at a 5% interest rate in twelve equal installments, repayment beginning three years after the completion of the project.
- (3) Bhutan will provide free land, timber and firewood for the project and will not impose taxes on construction materials and capital goods procured for the project.
- (4) Employment at the project will be restricted to nationals of Bhutan and India. If necessary, low skilled staffs and laborers could be imported from a third country.

³ The contract was reviewed in 1995 and single negotiated price was agreed upon for sale of electricity to India

(5) Taking into consideration the time-series data of the previous 20 years, both Bhutan and India agreed upon prices for firm and secondary energy. In 1988 rupees, the selling price of firm energy would be Rs 0.27/kWh and secondary energy Rs 0.135/kWh. Out of its total generation, only 832 million kWh per year is to be considered as firm energy.

(6) Electricity derived from the project is to be supplied only to Bhutan and India. For 99 years India will buy all the electricity generated from the project in excess of Bhutan's requirements. The sales price of electricity to India shall be revised by the two governments after the end of each 4 year period. The reviews are to be guided by the following criteria.

- (i) Increase in operation and maintenance costs of the Chukha project.
- (ii) The average percentage increase in the cost of generation of hydro-electric power during the previous four years in the Eastern-North Eastern region of India.
- (iii) Any other factor relevant at that time.
- (iv) No duty, surcharge or any other form of levy is to be charged by Bhutan on the power sold by Bhutan to India.

Any disputes concerning the arrangement are to be settled by an independent jury instituted jointly by Bhutan and India. Members of the jury are to be either citizens of Bhutan or India; the chairperson, however, is to be nominated by Bhutan.

FINANCIAL MODEL

To model the financial cash flows of the project we consider that the project generates Q_t^p million kWh of electricity annually. Of this quantity, an amount, equal to Q_t^A million kWh, is used as auxiliary consumption, Q_t^d million kWh is supplied to domestic consumers, and Q_t^x million kWh is exported to India. The annual production has varied from year to year depending upon the availability of water in the river. The energy balance is shown as:

$$Q_t^p = Q_t^d + Q_t^x + Q_t^A \quad (1)$$

For the estimation of financial NPV from the viewpoint of Bhutan, the project is evaluated for inflows and outflows including the residual values reported in 2024, the final year of the analysis. The present value (PV) of inflows from the beginning of the project through to 2024 comprises the discounted values of the capital subsidy (CS_t)⁴, the domestic cost savings and revenue (DR_t) from the sales of electricity to Bhutan⁵, the export revenue (ER_t) from the sales of electricity to India⁶, the receipts and recovery (RR_t) during the construction period⁷, and the residual values (RV_t) of the project in year 2024⁸. It can be expressed in 2008 values as;

$$\text{PV of INFLOWS as of 2008} = \{\sum(CS_t + DR_t + ER_t + RR_t + RV_t)\} * (1+r)^{(2008-t)} \quad (2)$$

The present value (PV) of outflows comprises the discounted value of capital cost (CC_t)⁹, recurring costs (RC_t)¹⁰, the changes in working capital (ΔWC_t)¹¹, periodic capital investment costs ($PCIC_t$)¹², and loan repayments (LR_t)¹³. It can be expressed in 2008 values as;

4The annual capital inflows from India to finance the construction costs is CS_t

5The domestic sales revenue can be expressed as $DR_t = Pdt * Qdt$, where the price (Pdt) and quantity (Qdt) of sales to Bhutan are determined from the previous year's records adjusted for growth rate for that particular year. The project began to sell electricity from 1987 and would continue until 2024. From 2006 onward, the cap for quantity of domestic sales is fixed at 280 million kWh.

6The export sales revenue can be expressed as $ER_t = Pxt * Qxt$, where the export tariff (Pxt) and the quantity (Qxt) sold to India are determined from the previous year's records adjusted for the growth rate for that particular year. The project began to export electricity from 1987 and would continue until 2024. In the past, the quantity of electricity exported to India declined with the growth rate in domestic demand.

7 Receipts and recovery realized by the project during the construction period (RR_t). It includes sales of used equipment, refund of advances to the contractors and other miscellaneous services provided by the project to outsiders.

8Residual values that would be realized at the end of the economic life of the project in 2024 (RV_t). It is estimated at 10% on 77% of the investment costs in 1989; 10% of 77% of the investment costs on additional tail race tunnel; and the book value of the capital expenditures on replacement of mechanical and electrical equipment that would occur in 2009, depreciated annually at 5%. Land which was provided free to the project was estimated to have a market value at Rs 60000 in 1974. The residual values would be realized in 2024 at constant real prices.

9 The capital investment costs that occurred during the construction period (CC_t). That is annual outflows from 1974 to 1989 and cost of the additional tail race tunnel that occurred from 1990 to 1994. This additional cost was financed with revenue flows from the project, hence not included in the estimation of annual loan repayments.

10The recurring costs comprising of overheads, maintenance costs and wheeling fee (RC_t). It covers the period from 1990 to 2004, during the operation period only.

11The changes in working capital (ΔWC_t) comprises the changes in accounts receivables, changes in accounts payables and changes in cash balance from 1990 to 2024. The working capital, which comprise of accounts receivables, accounts payables and cash balance, were estimated at 8.33% of sales revenue and operating costs, respectively

$$\text{PV of OUTFLOWS as of 2008} = \{\sum(\text{CC}_t + \text{RC}_t + \Delta\text{WC}_t + \text{PCIC}_t + \text{LR}_t)\} * (1+r)^{(2008-t)} \quad (3)$$

The difference between the PV of inflows and outflows yields the net present value (NPV) for Bhutan. The present values are calculated by discounting the net cash flows from 1974 through 2024 by using the real discount rate of 10.5%¹⁴.

$$\text{NPV as of 2008} = [\text{PV of INFLOWS} - \text{PV of OUTFLOWS}] \quad (4)$$

FINANCIAL BENEFITS TO BHUTAN

The project began power generation in 1987. India handed over the project to Bhutan in 1989 upon commissioning of all the generating sets at the power plant. On the average, from 1990 to 2008, the project generated annually 1,747 million kWh of electricity¹⁵. Upon the completion of the additional tail race tunnel in 1993, annual energy generation has fluctuated from the minimum of 1,623 to the maximum of 2,117 million kWh. The auxiliary consumption, on the average, has remained at 0.39% of the total generation [SYB, 2006]

The recurring costs for the project, paid for by Bhutan, are made up of: overhead costs, maintenance costs and a wheeling fee. In 2008 prices, the average recurring costs of 18 years was 22.33% of the annual revenue. The annual real increases in overheads and maintenance costs averaged over the period were 6.93% and 7.91%, respectively [SYB, 2000, 2006]. These increases primarily came from real wage increases, increases in the real prices of repair and maintenance costs, and the cost of repairs to the infrastructure due to the damage caused by the monsoon rains. The wheeling fee paid to Bhutan's Department of Power is for delivery of the electricity to the Indian transmission network at the border.

Repayments of the loan were made on a bi-annual basis. As agreed upon in the contract, the total repayment was calculated based on 40% of the capital inflows from 1974 through 1989, using a fixed nominal interest

12The Periodic Capital Investment Costs (PCICt). It is the cost of major repair and maintenance or replacement of mechanical and electrical equipment. The project had to invest Rs 136.11 million in 2002; Rs 418.39 million in 2003; and it is required to invest Rs 5170 million in 2009—all in 2008 prices

13The loan repayments (LRt). It started in June 1993 and would end in June 2008.

14 The real financial discount rate for Bhutan is considered to be same as the social discount rate, which is approximated to equal to the social opportunity cost of capital for India.

15 The complete set of financial and economic model of the project's financial and economic resource flows can be downloaded from www.queensejdiexec.org/research

rate of 5%. As the average inflation rate from 1993 to 2007 was 5.9% [SYB, 2006], the real values of annual repayments have been falling due to the negative impact of inflation on the value of the real interest rate. Expresses in 2008 prices, the first bi-annual repayment made in 1993 amounted to Rs 168.93 million. By 2008 the real value of equal bi-annual repayment was eroded by inflation to Rs 77.18 million. Inflation reduced the real present value of the loan repayments by 35.7%¹⁶.

From commencement to the end of 2008 Bhutan has earned Rs 28,648 million (2008 prices). The annual real revenue flows to Bhutan from 1990 to 2008 are shown in Figure 1. The changes in revenue reflect the revisions of the export tariff and the fluctuations in energy generation. On average, the annual real increase in export tariff was 13.9% although there was a time lag between the real increase in recurrent costs and the subsequent increases in the export tariff. The export tariff in 2005 was negotiated to be Rs 2.0/kWh, which in 2008 prices translates to Rs 2.28/kWh. The levelized domestic sale price of electricity over the period from 1990 to 2008 was Rs 0.38/kWh (2008 prices). These values are projected to remain constant in real terms in the calculation of future revenue for Bhutan.

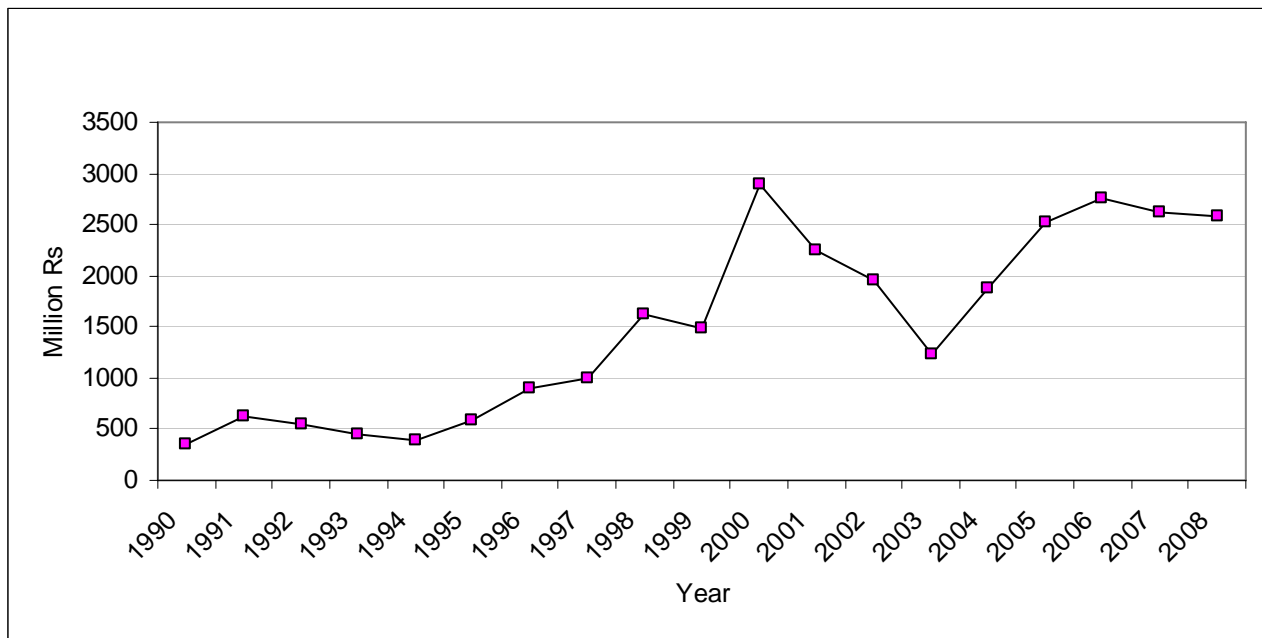


Figure 1: Annual Revenue Accruing to Bhutan (2008 Prices).

¹⁶ The present value was calculated using a real rate of discount of 10.5% that was obtained from Shukla, G.P., and Rangan (1997).

The financial NPV of the project as of 2008 is estimated at Rs 55,111.1 million or USD 1,170.6 million (2008 prices). The project has had a comfortable cash position to service the loan. Its lowest annual debt service coverage ratio was 2.28 in 1994. There was a steady increase in total revenue generation because of the revisions in export tariff. The annual real revenue received by Bhutan (2008 prices) was a minimum at Rs 354 million in 1990 and the maximum of Rs 2,887 million in 2000. This provided substantial net income to Bhutan after deducting the recurrent costs.

ECONOMIC NET BENEFIT TO BHUTAN

The contractual agreement stipulates that India would buy all the electricity generated by Chukha in excess of Bhutan's requirements. Figure 2 illustrates the movement of the demand for electricity in Bhutan over time. In 1987 when the project started generating electricity, the total requirement of electricity in Bhutan was 70 million kWh [SYB, 1991]. This quantity of electricity, Q_b in figure 2, was imported from India. The Department of Power, Royal Government of Bhutan, served as the sole supplier and distributor of electricity in the country.

The project supplied to Bhutan 5.64 million kWh in 1987 and 38.23 million kWh in 1988. Electricity from Chukha replaced the entire import of electricity from India by 1989 when the total consumption of electricity in the country rose to 130 million kWh [SYB, 1991]. In the first two years when electricity generation from the plant was not at its full capacity, the project supply substituted for a fraction of the electricity previously imported.

From 1989 onward the project not only replaced imports but made the electricity available at a lower price P^a . The gains to the country in terms of the savings from reduced electricity purchases at a price of P^b from India are shown in figure 2. When the electricity price was reduced from P^b to P^a , the quantity of electricity demanded increased from Q^b to Q^a . Thus, the total consumer surplus benefit to Bhutan in 1989 is shown by the area P^bACP^a . This includes the gain received from the reduced cost of the quantity previously imported, P^bABP^a , plus the gain in additional consumer surplus from the increase in quantity of electricity demanded due to the lower price (ABC).

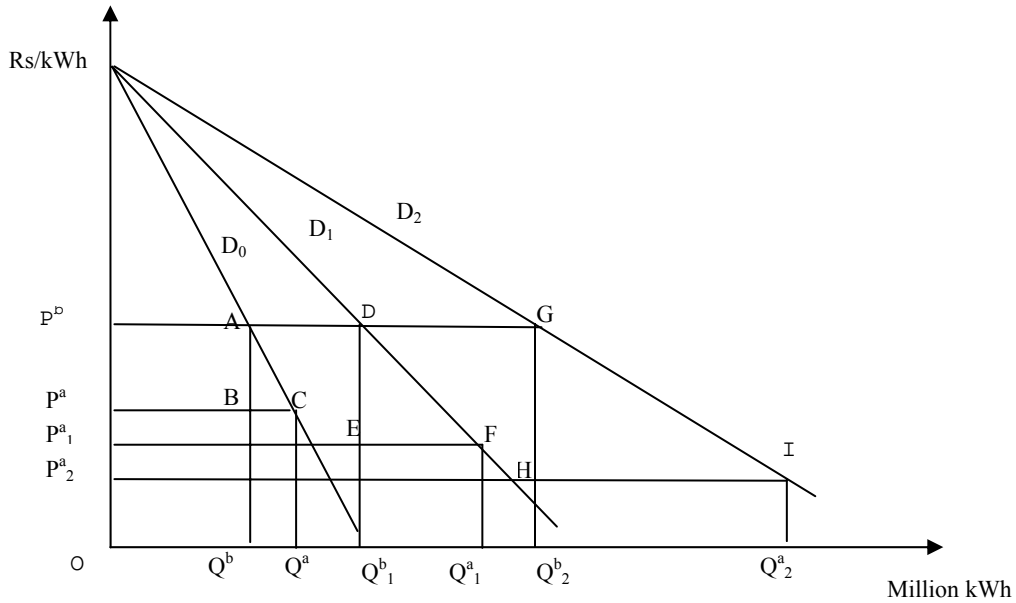


Figure 2: Domestic Supply with Growth in Demand

The estimate of P^b is derived from the price of electricity that the consumers paid without the project. In 1987, the consumers paid Rs 0.70/kWh [SYB, 1991]. Out of this savings the Department of Power spent Rs 0.17/kWh for transmission and distribution in addition to T&D loss of 15% [SYB, 1991]. Hence, the value at the bus bar in 1997 of Chukha electricity derived from the cost of imported electric energy is: $\text{Tariff}_{(1989)} - \text{TD}_{\text{cost}} - P_0^* \text{TD}_{\text{loss}}$ or $0.70 - 0.17 - 0.105 = 0.43$ Rs/kWh. In 2008 prices this amounts to Rs 2.02/kWh. This is the maximum economic value per kWh of electricity from Chukha as derived from the willingness to pay of domestic consumers for electricity. This value is assumed to remain constant in real terms for the entire evaluation period. We do not know what India would have charged Bhutan for electricity during the period if Chukha did not exist; however, it is highly unlikely to be a lower price.

In contrast, the project charged Bhutan's consumers at the bus-bar Rs 0.10/kWh from 1989 to 1994 and has maintained a constant nominal value of Rs 0.30/kWh from 1994 to 2007. This constant nominal price of electricity for domestic consumers has resulted in declining prices (P^a_t) in real terms from 1994 to 2007 due to inflation. The levelized value of the domestic tariff for the period 1990 to 2005 was Rs 0.38/kWh in 2008

prices. This value, maintained in real terms, is adopted for the estimation of the domestic tariff beyond 2009¹⁷.

In addition, there are savings in expenditures on imported electricity due to the growth in domestic electricity demand. On average, the electricity demand grew at 10.4% per year from 1990 to 2005 [SYB, 1995, 2000, 2006]. It was fueled by the establishment of new energy intensive industries recording quantum jumps of 30% in 1992, 41% in 1995, 28% in 1996, and 46% in 2002. There was also a surge in rural electrification, particularly in western Bhutan, and an increase in the use of electrical appliances among the urban population. Thus, the quantity of electricity supplied by Chukha for domestic consumption increased from 130 million kWh in 1989; to 305 million kWh in 1995; to 483 million kWh in 2000; and to 450 million kWh in 2004¹⁸[SYB, 1991, 1997, 2000, 2006]. From 2005 onward the supply from Chukha to the domestic market is capped at 255 million kWh by the amendment of the project agreement with India [SYB, 2006]

The growth in domestic demand for electricity can be attributed to both the growth of income and the effect of lowering the real price of electricity. The income effect primarily causes the demand curve to rotate outward. The shift of the demand curve from A to D and from D to G in figure 2 can be considered as the measure of electricity growth in year 1 and year 2, respectively, due to the income effects. The corresponding shifts from E to F and from H to I are due to the fall in the real value of electricity price from P^b to P^a to P^a_1 and P^a_2 , respectively. The additional economic gains to Bhutan due to the increase in domestic demand and the reduction in the real value of the tariff is measured by area $P^bDFP^a_1$ for year 1 and area $P^bGIP^a_2$ for year 2. These areas could be divided into economic gains due to the savings in tariff expenditures and increases in consumer surplus. Area $P^bDEP^a_1$ measures the savings in tariff expenditures for year 1 and area $P^bGHP^a_2$ for year 2. Similarly, area DEF measures the additional consumer surplus for year 1 and area GHI for year 2 that are brought about by the increase in the quantity of electricity demanded due to the fall in the real price of electricity over time. Thus, the economic benefit from the increase in domestic consumption due to the income effect for any time “t” can be estimated as: $STE_t = (P^b - P^a_t) * Q^b_t$. Similarly, the economic benefit of increase in domestic consumption due to price effect for any time “t” can be estimated as: $CS_t = 1/2 * (P^b - P^a_t) * (Q^a_t - Q^b_t)$.

17 Bhutan Electricity Act(2006)provides provisions for periodic revision of tariff to account for erosion in the real value due to price inflation or cost escalation.

18 The decrease in Chukha supply is attributed to production from other supply sources, particularly smaller hydro, from 2000 onward.

The annual demand for electricity in Bhutan for the period 1990 to 2005 is as recorded [SYB, 1991, 1195, 2000, 2006], and the projection of demand for the years beyond that point are estimated by using the relationship: $Q^a_t = Q^a_{t-1} * (1 + g^e_t)$, where g^e_t is the projected annual growth rate in electricity demand. The projected growth in electricity demand in Bhutan is estimated at 8% per year based on the projected increase in Bhutan's real income over time [Planning Commission, 2001]. The increase in electricity demand due to income growth alone can be derived by using the relationship: $\Delta Q^b_t = Q^b_{t-1} * \eta_I * \Delta Y/Y$, where, η_I is the income elasticity of demand for electricity, and $\Delta Y/Y$ real growth of gross national product, expressed as a proportion of the previous year's income. The income elasticity of electricity for Bhutan is assumed at 1.45, and the growth rate in gross national product for the period 1990 to 2005 are as recorded [SYB, 1995, 2000, 2006], and the projection of the growth rate of GNP for beyond 2008 is estimated at 6% [SYB, 2006].

During the construction period Bhutan did not benefit much from the opportunities created by the capital investment. The Bhutanese economy did not have the required absorptive capacity, and the goods and services used in the projects were exempted from any kind of taxes or import duties. There were hardly any Bhutanese employed by the project as most of the work contracts went to Indian nationals. After the commissioning of the project many Bhutanese were employed. Bhutanese nationals, in 1990 constituted about 13% of the total workforce, but by 2005 they had increased to 75% [SYB, 2006]. The Bhutanese workers at the Chukha project receive an additional allowance of 15% on top of their base wages while at the same time they are required to pay personal income taxes at a rate of 15% on their gross earnings. In addition, the government collects a 15% sales tax on the plant maintenance cost that constitutes, on the average, about 22.33% of the recurring expenditures. These tax externalities (TE_t) accrue as benefits to the government.

Thus, the present values of the net economic benefits to Bhutan as of 2008 are made up of four components as expressed in equation (5): The present value of cash flows from the project; the present value of savings (price differential) from the reduced imports of electricity; the present value of the consumer surplus from the increase in the quantity demanded; and the present value of tax externalities.

$$NEB (\text{Bhutan}) = NPV_f^b + \sum \{STE_t + CS_t + TE_t\} * (1+r)^{(2008-t)} \quad (5)$$

Where,

NPV_f^b = Financial net present value in 2008 prices evaluated as of 2008 to Bhutan while using an economic discount rate of 10.5%.

- STE_t = Savings of expenditures on import of electricity from India from 1987 through 2023 because of the lower price of electricity from Chukha.
- CS_t = Consumer surplus generated by increase in the quantity of electricity demanded from 1989 to 2005.
- TE_t = Personal income tax from Chukha's employees and sales tax collected on recurring expenditures. The tax collections began only from June 1992 when the project was handed over officially to Bhutan government.
- $(1+r)^{(2008-t)}$ = discount factor, where $r = 10.5\%$, and "t" varying from 1974 to 2024

As of 2008 the net present value of the economic benefit of the project to Bhutan evaluated in 2008 prices is estimated at Rs 107,647.24 million or USD 2,286.51 million¹⁹. Of this, the consumers captured USD 1081.18 million as consumer surplus, Bhutan government received USD 34.73 million in taxes, and the project itself received a net present value of USD 1170.60 million. These latter benefits will become part of the non-tax revenue of the government.

ECONOMIC BENEFITS TO INDIA

The Chukha project created a net present value of USD 2,286.51 million as economic benefits to Bhutan with little of its own investment as India financed the entire capital cost within a turnkey arrangement. Of the total capital cost, 60% was given as financial grant to Bhutan. Of the remaining 40%, Bhutan repaid, after three years of grace period, in 15 equal installments at a fixed nominal interest of 5%. Given these values we wish to find out what was the incentive for India to make such a large amount of investment on the Chukha Hydel Project, and has it gained or lost from this investment?

Chukha's generation is supplied through a transmission line connected to India's Eastern Electricity Region. In 2007, the region had 17,754.5 MW of installed capacity [Maheshwari, Shushmul, 2008]. About 82% of the total capacity is made up by 112 thermal power plants, each with a capacity varying from 6 to 500 MW. These plants are operating at a capacity utilization factor varying from 45% to 80%. The component of gas-fired plants makes up a total of 183 MW, which have operated on the average at a plant load factor of 17%. Hydropower constitutes 3,175.5 MW of the total capacity, or 18% in the total, and contributes to both

meeting the demand for peak load as well as the base load [Maheshwari, Shushmul, 2008] The region has developed most of its potential hydroelectric sites. Figure 3 below depicts the characteristics of an annual load duration curve for India’s Eastern Electricity Region.

Gas-fired plants are the alternative to Bhutan’s peak load hydroelectricity; fuel efficient super-thermal coal-fired plants are the alternative to base load hydropower; and fuel in-efficient, old thermal power plants, which have larger operation and maintenance costs, are the alternative to intermediate load electricity provided by Chukha. Table: 1 below shows the breakdown of Chukha’s annual electricity generation into consumption in Bhutan and electricity exports to India [SYB, 1991, 1995, 2000, 2006]. These are average figures for the bracketed periods depicting the share of peak, firm and intermediate load electricity supplied from Chukha for the years 1989-93, 1994-98, 1999-03 and 2004-24. There was no base-load supply to India from Chukha from 1999 to 2003 because of the increase in electricity demanded by Bhutan.

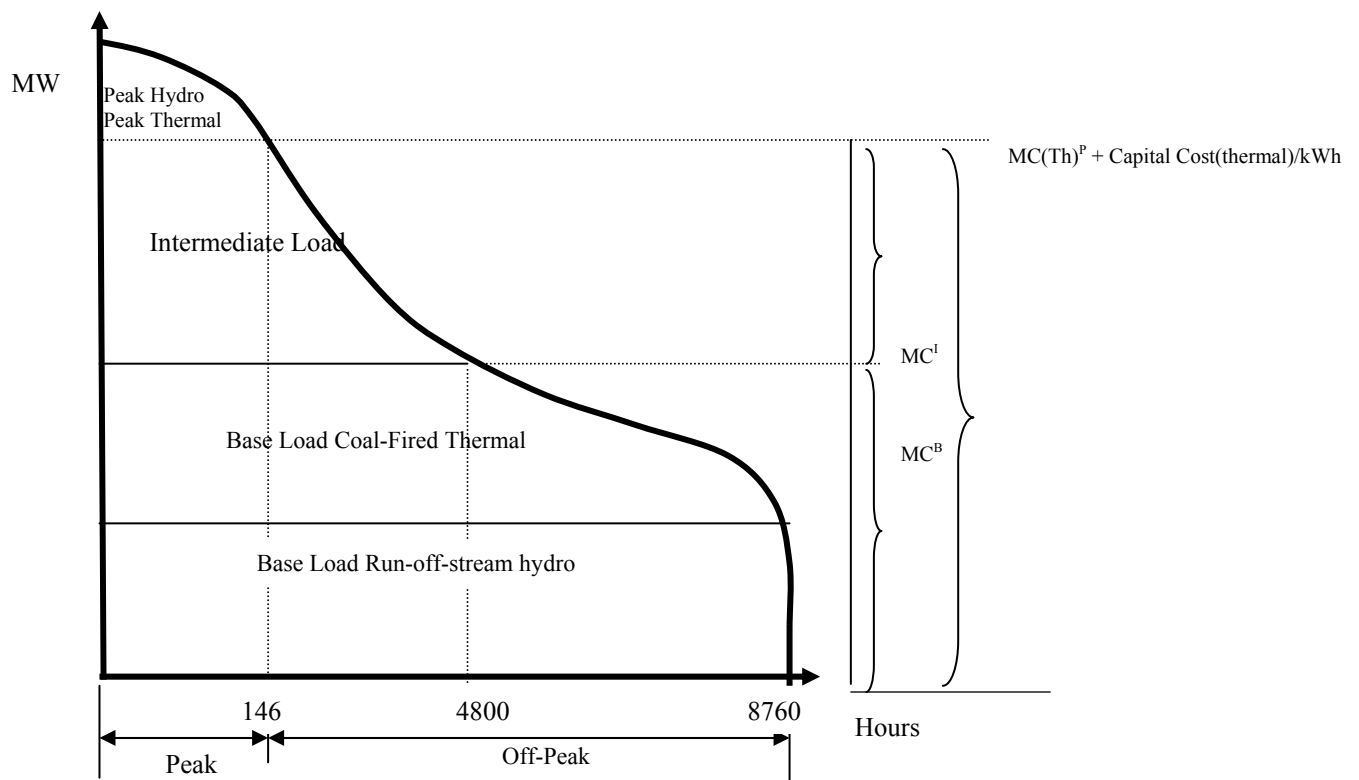


Figure 3: Load Duration Curve of Eastern Electricity Region, India

Table 1. Electricity Generation, Chukha Hydroelectric Project

19 It is assumed that the market value of land captures the foregone benefits of agricultural production and negligible costs or benefits are associated with this project from other sources.

| Period | 1989-93 | 1994-98 | 1999-03 | 2004-24 |
|--|---------|---------|---------|---------|
| Total Availability, Million kWh | 1551.37 | 1761 | 1952.07 | 1745 |
| Supply to Bhutan, Million kWh | 138.75 | 322.70 | 456.44 | 254.95 |
| Supply to India, Million kWh | 1381.52 | 1431.0 | 1495.63 | 1483.25 |
| Peak Load Electricity, Million kWh | 467.20 | 460.32 | 414.96 | 467.20 |
| Base Load Electricity, Million kWh | 226.05 | 48.98 | 000.00 | 109.85 |
| Intermediate Load Electricity, Million kWh | 688.27 | 921.48 | 1080.67 | 906.20 |
| Share of Peak Load | 0.34 | 0.32 | 0.28 | 0.31 |
| Share of Base Load | 0.16 | 0.03 | 0.00 | 0.07 |
| Share of Intermediate Load | 0.50 | 0.64 | 0.72 | 0.61 |

The Chukha's engineering design provides an opportunity to use for four hours each day the full 336 MW of the capacity, generating annually 467.2 million kWh of electricity during the peak periods. This leaves 356.8 million kWh of firm energy to split between the consumption in Bhutan or export to India as base load electricity²⁰. The remaining is the seasonal energy which is supplied to meet the intermediate load demand during the monsoon months.

Thus, if α_t , β_t and δ_t are the share of peak, firm and intermediate loads from the annual electricity import from Chukha, and if C_t^P , C_t^B and C_t^I are the avoided cost of supplying the peak, base and intermediate load electricity in the Eastern Electricity Region, the economic value of Chukha electricity (EVCE_t) to India for any year, t, is:

$$EVCE_t = \alpha_t * C_t^P * Q_t^I + \beta_t * C_t^B * Q_t^I + \delta_t * C_t^I * Q_t^I \quad (6)$$

Where,

$$\alpha_t + \beta_t + \delta_t = 1$$

$Q_t^I = Q_t^X * (1-k)$; where, k is the loss of electricity during the high voltage transmission from Bhutan. These losses are estimated at 4.5% of the total electricity delivered at the border, Q_t^X .

$\alpha_t = 0.34$ for 1989 to 1993; 0.32 from 1994 to 1998; 0.28 from 1999 to 2003; and 0.31 from 2004 onward.

$\beta_t = 0.16$ for 1989 to 1993; 0.03 from 1994 to 1998; 0.00 from 1999 to 2003; and 0.07 from 2004 onward.

²⁰The bilateral contract recognizes 832 million kWh as firm energy and 1300 million kWh as seasonal energy from the total annual supply. The capacity of the plant was expanded to 370 MW from 1994 onward to take advantage of monsoon water flow for few months in some years. For our analysis we will treat the capacity of the plant as 336 MW.

$\delta_t = 0.50$ for 1989 to 1993; 0.64 from 1994 to 1998; 0.72 from 1999 to 2003; and 0.61 from 2004 onward.

There were outflows of capital from India from 1974 to 1993 and inflows of repayments from 1993 to 2008. Thus, the stream of net investment cost for India can be shown as:

$$NIC_t = \sum CI_t - \sum REP_t \quad (7)$$

Where,

(CI_t) are the costs during the construction period and REP_t denotes the loan repayments made to India by Bhutan.

For the electricity India pays a flat tariff for delivery at the border. In 2008 prices, export tariff (ET) was Rs 1.23 per kWh when the project began electricity generation. The tariff been revised several times. Since 2005 India has been paying Rs 2.0 per kWh in nominal value. Thus, India's annual expenditure (AE) for import of Chukha electricity is:

$$AE_t = Q_t^X * ET_t \quad (8)$$

Thus, the net economic benefit for India from the investment on the Chukha project is obtained from equation (6), (7) and (8) and adjusting for any externalities (EX_t) associated with the foreign exchange premium, taxes and subsidies in supply of goods and services, and environmental benefits or costs associated with the supply of Chukha electricity. The present value of the net economic benefit to India in 2008 is expressed as:

$$NPV = \sum \{EVCE_t - (NIC_t + AE_t) \pm EX_t\} * (1+r)^{(2008-t)} \quad (9)$$

AVOIDED COST OF PEAK LOAD ELECTRICITY

India has used Chukha's supply to meet its peak load electricity demand because the import price is the same whether the electricity serves peak load or base load demand. The substitute for peaking electricity from Chukha is generation from gas-fired plants. The generation cost of gas-based electricity supply can be

split into capital cost (K_t), fuel cost (F_t), variable repair and maintenance cost (RMC_t)²¹, and fixed maintenance and overhead (FMO_t)²². India imports natural gas. The cost of fuel needs to be adjusted for changes in its real price and for the cost of foreign exchange premium²³. Assuming the share of tradable content in the (RMC_t) at 80%, the estimate of the avoided economic cost of peaking electricity from a gas-fired power plant is:

$$C_t^p = K_t + F_t(1+g_t) + RMC_t + \rho_t * \{K_t + F_t(1+g_t)\} + 0.80 * \rho_t * (RMC_t + FMO_t) \quad (10)$$

Where,

g_t : real growth rate in price of natural gas.

ρ_t : The foreign exchange premium (FEP).

In 2008 prices, capital cost of a gas-fired plant in India is USD 580 per KW of installed capacity [Nuclear Energy Institute, 2008]. The eastern electricity region had been experiencing a shortage of peaking load capacity. Assuming the opportunity cost of capital for power sector at 9.5% (real), replacement cost of wear and tear at 5% of the capital cost, and the average plant load factor of 17%, the financial capital cost (K_t)/kWh to substitute the peak load supply from Chukha is estimated at USD 0.056/kWh²⁴. Specific fuel consumption for gas-fired plant is 8.21 MJ/kWh, and the international price of gas on the average over the project life is assumed at USD 10.0/GJ in 2008 prices. This yields the fuel cost (F_t) of USD 0.10/kWh. Assuming the average FEP for India over the life of project at 10%, and substituting the values of these variables in equation (11), the avoided economic cost of peaking electricity from the Chukha supply is estimated at USD 0.17/kWh in 2008 prices²⁵. In rupee it translates to Rs 7.18 per kWh²⁶.

21 RMCt : Variable repair and maintenance costs, which is estimated to be USD 0.8/MWh for the gas-fired pant in the Eastern Electricity Region in 2000 prices. This translates to USD 0.0008/kWh in 2008 prices.

22FMOt: Fixed maintenance and overhead expenses, which is estimated to be USD 1670 per MW per month for the gas-fired pant in the Eastern Electricity Region in 2000 prices. This translates into USD 0.015/kWh in 2008 prices for 336 MW of peak power supplying 467.2 million kWh of electricity annually.

23 The price of LPG has been volatile in the international market. The landed price of gas at the port in India was USD 11.64/ million BTU in 2000 prices, which is equivalent to USD 13.83/GJ in 2008 prices . But the government maintains an administered price for gas, which is much lower than the cost of supply.

24Capital Cost = USD 380; peaking hours= 1760; opportunity cost of capital = 9.5% real; and replacement cost = 5%; and foreign exchange premium = 10%. This on per kWh basis amounts to USD 0.056 of electricity supply in 2008 prices.

25 In May 2001 the generation cost of Dobal Power Pant in Maharashtra was Rs 8.75/kWh, which is a Naptha-based base load generation pant. At the exchange rate of Rs 45/USD, the cost of generation translates into USD0.19/kWh in 2001 prices and USD 0.23/kWh in 2008 prices.

26The exchange rate in 2008 is Rs 47/kWh.

AVOIDED COST OF BASE LOAD ELECTRICITY

The avoided cost of firm electricity supply is equal to the fuel savings in super-thermal coal-fired power plants. Such super-thermal power plants are built near to large open-pit coal mines, avoiding the long-haul transportation cost. The average heat rate for Indian coal is 15500 BTU/kWh (Guha, 2003), and the average cost of Indian coal at the pit head is estimated at USD 1.45 /Million BTU (IEA, 2000) in 2008 prices. This translates into the cost of fuel in a coal-fired super-thermal power plant at USD 0.025/kWh in 2008 prices. In addition USD 0.0016/kWh is required in 2008 prices to cover the non-fuel variable operating cost. This includes the cost of furnace oil to mix with pulverized coal for making the fuel spray and the cost of ash handling²⁷. The Indian coal used in the power plant has an ash content between 35 to 50 percent²⁸ (IEA, 2000). Thus, the avoided cost of base load electricity supply in the Eastern Electricity Region is:

$$C_t^b = F_t^c * (1+g_t^c) * (1+ \rho_t) + RMC_t + 0.80 * \rho_t * RMC_t \quad (11)$$

Where,

F_t^c : cost of coal per kWh

g_t^c : real growth rate in coal price

RMC_t : variable repair and maintenance cost per kWh

With zero growth rate in the real price of coal, a foreign exchange premium of 10%, and substituting the values of other variables into equation (11), the avoided cost of base load supply is estimated at USD 0.026/kWh in 2008 prices. In rupee this translates to Rs 1.25/kWh.

AVOIDED COST OF INTERMEDIATE LOAD ELECTRICITY

The avoided cost of using the seasonal electricity from Chukha can be assumed to be the fuel cost of the most fuel-inefficient thermal power plants that will be operated at a low plant load factor. Of 112 thermal power plants there are 103 coal-fired plants with a wide variation in specific coal consumption from 0.56 to 0.99 kg per kWh of generation, the most fuel-inefficient being the 720 MW Muzaffarpur coal-fired Plant in

²⁷Each kWh of electricity requires 6.1 ml of furnace oil.

²⁸ Each kWh of electricity generates 0.26 kg of fly ash.

Bihar [CEA, 2002]. Such plants have an annual planned maintenance schedule of 864 hours, which could be equivalent to 36, 54 or 108 days depending upon whether the working hours per day is 24, 16 or 8 hours, respectively. This means that secondary electricity generated during the monsoon months could be used as a substitute for the generation from such power plants scheduled for annual maintenance. Thus, if the electricity generated in the system is based on the optimal stacking method; the marginal cost of the intermediate load electricity from Chukha is the fuel cost of a gas-fired plant, which is equal to USD 0.09/kWh, or equivalent to Rs 4.25 per kWh in 2008 prices.

Thus, the net economic benefit for India can be estimated from equation (9) since the values of all the variables are known except for the environmental externalities. Chukha's economic rate of return for India is 13.72%, generating as of 2008 Rs 118,724 million in net economic value, equivalent to a net present value of USD 2,522 million in 2008 prices. The additional benefits to India due to ash handling and avoided cost of pollution from CO₂, SO₂, NO_x and particulate matter are not included in this estimate.

RISK SHARING AND RISK MANAGEMENT

The bilateral contract provided India with the scope to manage the project risk to its advantage, while not penalizing Bhutan's economic benefits of the project in the long run. India absorbed the construction risk and market risk by agreeing to provide the required capital, construct the project in a turnkey arrangement, and off-take the excess supply of electricity from Chukha over the domestic consumption at a mutually agreed upon price subject to periodic revisions for inflation and cost escalation. The calibration of the import price of electricity vis-à-vis the hydroelectricity rent associated with Chukha Hydel Project has been the basis of risk sharing and management for India.

Hydroelectricity rents in theory are the economic surpluses created by the difference between the economic costs of supply from hydroelectric sites and the avoided costs of electricity supply from alternative sources. Therefore, the hydroelectricity rent is dependent not only on the economic cost of generation from a specific site but also on the cost of electricity from alternative sources to replace the hydroelectricity of Chukha.

India provided 60% in grant and 40% in loan to finance the required capital cost. The loan carried a 5% fixed interest rate to be repaid in 15 equal installments beginning the first repayment in June 1993. The net present value of capital cost (real), including its opportunity cost, for India in 2008 is given as:

$$CC(\text{India}) = \{\sum CI_t * (1+r)^{(2008-t)}\} - \{\sum REP_t\} * (1+r)^{(2008-t)} \quad (12)$$

Where,

CI_t : are the streams of capital inflows to the project as investment subsidy from 1974 through 1993. The estimation is carried out as of the year 2008, taking into accounts the opportunity cost of funds “r”.

REP_t : are the streams of repayments received by India starting from 1993 to 2008. India in return received a reliable source of hydroelectricity supply at a negotiated price. The contract for the supply is valid for 99 years. The levelized investment cost K_c for India is estimated at Rs 1.88/ kWh (2008 prices) by using the relationship given in equation (14).

$$K_c = [\{\sum CI_t * (1+r)^{(2008-t)}\} - \{\sum REP_t\} * (1+r)^{(2008-t)}] / [\{\sum Q_t^I\} * (1+r)^{(2008-t)}] \quad (13)$$

Where,

Q_t^I : Quantity of electricity imported by India from 1987 to 2024.

REP_t : Repayment of loan is from 1993 to 2008.

CI_t : Capital inflow is from 1974 to 1993

In addition to the investment cost India pays a negotiated export tariff (ET_t) and bears the marginal cost of transmission (MCT) from Bhutan to its consumption centers in eastern electricity region. Hence, the supply price (P_t^s) of Chukha electricity for India is: $P_t^s = K_c + ET_t + MCT$. The supply price is estimated at Rs2.84/kWh in 1990 including the bulk transmission loss of 4.5% and wheeling cost of Rs 0.15/kWh in 2008 prices. As discussed in economic analysis, the avoided cost (AC_t) of Chukha supply to India can be approximated as: $AC_t = \alpha_t * C_t^P + \beta_t * C_t^B + \delta_t * C_t^I$. The avoided cost is estimated at Rs 4.96/kWh in 1990 at 2008 prices.

As shown in Figure 4 the hydroelectricity rent accruing to India changes with changes in the supply price, which in turn is a dependent on the negotiations of the export tariff. Area ABCD estimates the rent to India when the export tariff per kWh is ET; the marginal cost of transmission per kWh is MCT; and the levelized capital subsidy per kWh is K_c . Hence, the present value of hydroelectricity rent (HR) can be estimated as:

$$PV \text{ of HR(India)} = \sum [\{\alpha_t * (C_t^P - P_t^s) + \beta_t * (C_t^B - P_t^s) + \delta_t * (C_t^I - P_t^s)\} * Q_t^I] * (1+r)^{(2008-t)} \quad (14)$$

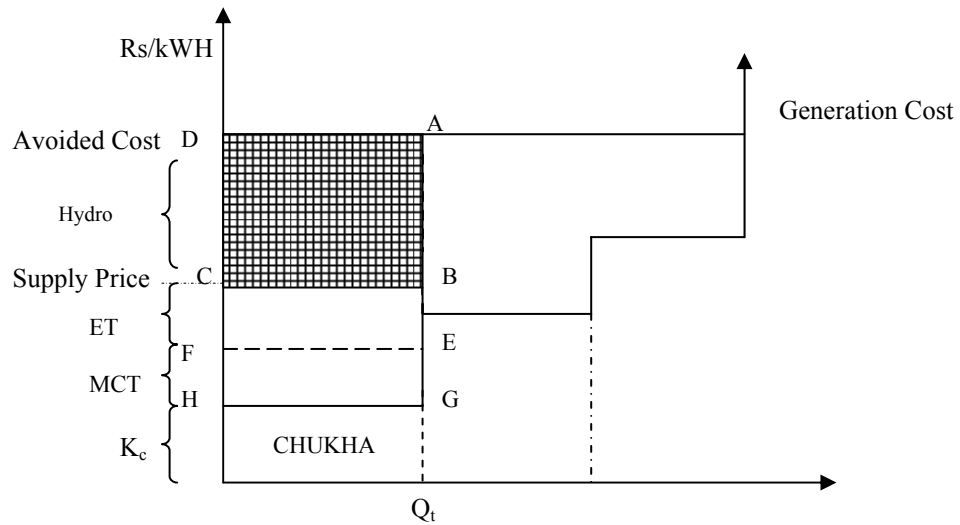


Figure 4: Hydroelectricity Rent of Chukha as Perceived by India

India's strategy might be to manage the diplomatic goodwill of Bhutan government by calibrating the import price of electricity vis-à-vis the relationship in equation (13) and equation (14). Given that India has strategic and economic interests in developing the vast, untapped hydropower potential of 30,000 MW in Bhutan, the calibration of import price was an important consideration in the bilateral negotiations. Chukha has been a major industrial project for Bhutan, contributing as much about 45% of the total revenue collected by the government in 2005 (ADB,2006). Obviously, India was not in favor of depriving Bhutan of its substantial electricity revenue by accelerating the recovery of its investment costs by taking a bigger share of the total hydroelectricity rent of Chukha Hydel Project in the early years of the project operation.

India calibrated the import price based on its assessment of the need to recover the capital investment with its opportunity cost. A part of the investment cost was paid by Bhutan in loan repayment. But the part of the investment costs that was given as a grant was in fact recovered by the capture of part of the hydroelectricity rent through low purchase price of electricity. India completed the recovery of the investment cost with its economic opportunity cost by 1997. This was the year India agreed to double the electricity export price paid to Bhutan. The last negotiation of the import price has split the rent in the ratio of 48:52 between Bhutan and India. If this price is kept constant for the remaining life of the

project, Bhutan and India will be sharing the hydroelectricity rent almost on an equal basis. The share of economic benefits to India would be higher if the benefits of avoided atmospheric pollutions, ash handling and carbon emissions are taken into account.

CONCLUSION

The Chukha Hydel project is an excellent example of bilateral cooperation in which both countries have gained economically. It would not have been possible for Bhutan alone to bear the financial risks in order to develop this project. India provided the technology and the financing, bore the completion risks, and received, in turn, a low-cost reliable source of hydroelectricity for its Eastern Electricity Region. The fruit of the cooperation is that Bhutan receives a substantial amount of revenue annually from a sustainable export of electricity and India is able to conserve its scarce fossil fuels while obtaining a real economic internal rate of return of at least 14%. The present value of net economic gains as of 2008 evaluated in 2008 prices has been USD 2,286.51 million for Bhutan and USD 2,521.78 million for India. Bhutan has received Rs 28,648 million in cumulative revenues since the commencement of the project through to 2008. By 2007 India had recovered its capital investment along with its opportunity cost through the receipts of loan repayments and the share of hydroelectricity rent generated at the project because of the lower import prices. When all the economic costs and economic benefits are taken into account, Bhutan and India end up sharing the net economic gains created by Chukha Hydroelectricity Project in the proportion of 48:52.

To date Nepal has avoided entering into an agreement with India to develop its hydropower resources as it has feared getting into an unbalanced arrangement where India might secure an unfair advantage. The experience of the Chukha dam in Bhutan might serve as a real life example of how such a power purchase agreement might be structured so as to yield a result that would be advantageous to both parties.

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