

D a b h o l c a s e s t u d y

Tu-22.439 Project finance

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BACKGROUND

Overview

In May 1992 India invited Enron Corp to explore the possibilities of building a large power plant in Maharashtra and already the following month a memorandum of understanding was signed. In December 1993 Maharashtra State Electricity Board(MSEB) signed a power purchase agreement with Dabhol power corporation(DPC). The power plant was planned to be completed in two stages. In 1995 after the state elections, the new government scrapped the project, alleging corruption and high costs. Later, in the same year the project was renegotiated and MSEB's stake was much higher than it had been in the initial contract. In May 1999 the first phase of the power plant was ready and begun operating. Maharashtra government allies wanted to stop the project because in their opinion the power produced was much too expensive, and shortly thereafter they default on their payments to DPC. In 2001 the problems continued and in April the board of DPC authorized the management to terminate the contract any time it chooses. Today the first phase of the plant is idle and the second is still not completed, Enron's part of DPC is for sale and a deadline for bids is on April 15.

Project structure

In this study, we analyse the Dabhol power plant project, a project in India that has been a disaster for all of the parties involved, and especially for Enron and the state of India. We identify the key issues and present some suggestions for how the problems could have been avoided.

Financial structure

The Dabhol Power Company was established in 1993 solely for the project. The designed project debt-equity ratio was 70:30, Enron being the sponsor of the \$2.9 billion project.

Lenders and insurers

The project debt arrangements were done by four international financiers; ANZ Investment Bank, Credit Suisse First Boston, ABN-AMRO, and Citibank. US government owned Overseas Private Investment Corporation (OPIC) supplied the project \$160 Mio loans and worth \$180 Mio in risk insurances. The other US Governmental institute, The American Export Import Bank, had issued worth \$300 Mio as direct loan.

State Bank of India, ICICI, Canara Bank, Industrial Finance Corporation of India, and Industrial Development Bank of India participated the project as domestic lenders. In January 2001 Reuters reported that the combined loan and guarantee exposure of the domestic lenders was roughly Rs 62 billion equalling to about \$1.4 billion.

The Government of Maharashtra (GoM) state issued an unlimited guarantee for MSEB's payment dues. The GoM's guarantee was the first to be invoked before filing any cases against MSEB. Guarantee also implied that the guarantor was responsible for the legal or other failures of the guarantee or the Power Purchase agreement. The Government of India issued a counter guarantee over all of its current and future assets excluding the military assets.

Equity investors

Three major equity investors participated the project with the sponsor Enron; MSEB with 15% share, and General Electric (GE) and Bechtel with 10% share each. MSEB was to pick up to 30% of equity in Phase two but it failed to raise the funds and left to 15%. On January 24th in 2001 the Cabinet Committee on Economic Affairs permitted Enron to enhance its stake in the project to \$1119.9 Mio.

Indirect credit support

The guarantees of both GoM and GoI have elements of indirect credit support in that by defaulting their obligations they would repel foreign investors. At stake is the prestige of the federal government in New Delhi and the state government of Maharashtra, which cannot afford to be seen to be violating a contractual agreement. Any incidents would affect India's image as a suitable destination for foreign investment. In case of problems India will eventually lose many millions of dollars of potential foreign investment if playing domestic politics with the national economy.

RISK ANALYSIS

Environmental and human rights risks

The Dabhol Power Project was in the focus of attention nationally and internationally because of the controversies surrounding the project's suspension. Thus, less attention was given to a pattern of serious environmental and human rights violations that the project provoked in localities near the site (Maharashtra state).

Subsequently, the environmental and human rights issues led to demonstrations and protests of activists, which in turn resulted in assaults and harassment of the local police and terrible abuse of the activists. Hence, the result was devastating violation of various human rights, which provoked environmental and human rights organizations to stand up and require changes in policies and regulations.

Next, the environmental and human rights issues and the resulting risks to the Dabhol Power Company are described.

Environmental risk

Concern over environmental impact fostered strong opposition to the project, mainly from the part of residents and fishermen in and around the plant area. The three primary areas of concern were:

- Pollution of fresh water
- Diversion of fresh water to the project site
- Potential contamination of salt water, which would adversely affect fishing communities
- Land acquisition for the project

The problem of water diversion became severe in 1996-1997. Namely, local water supplies were diverted to the project (8,338 litres per minute) at the expense of the villagers. The company only agreed to supply the amount of water that wells and tankers could bring to affected villages. Thus, Enron's programs only provided 40,000 litres of water per day, as opposed to 300,000 litres of water available to the villagers before the project.

The problem was compounded by severe contamination of potable water as a result of the project. Villagers used to have drinking water 24 hours a day. However, since the project started, they only had one hour of water a day. In contrast, DPC had its own pipeline and wasted water regularly. Villagers had to go to the river to get water, but now the water, as a result of the untreated sewage dumped into the river, was not potable anymore.

Assignment

The other water-based issue of concern, particularly to fishing villages, was the effect of hot-water discharge into bodies of water where fishing took place. In particular, the water was first used to cool the Dabhol Power plant and once the water was circulated through the plant, it was discharged back to the sea at a higher temperature. The water, which also contained toxic effluents, was expected to raise the temperature of the water and cause pollution which would kill fish and prawns, thereby destroying fisher peoples' means of subsistence (about 2,000 families of fisher folk were living off fishing done near the seashore). These concerns were raised in 1993, when individuals sent letters of objection to the company during the two-month notification period. In particular, DPC complied with the law in posting a notice in a local newspaper stating it was constructing power and would be acquiring land for the purpose of advising any person with an objection to notify DPC within two months of the publication of the notice. However, DPC falsely wrote to the government stating that they had received no objections.¹

In addition, as the plant needed land that currently belonged to farmers (a total of over 90,000 people), large-scale relocation of farmers was required for the construction of the Dabhol plant. To make matters even worse, the government decided to begin acquiring land for the project without consulting the public and the disclosure of information on environmental impact and land acquisition was severely neglected.

Eventually, local people organized into groups to protest the project. Most of these organizations were made up of social activists, lawyers, local political leaders, environmentalists and villagers. Local opposition to the project began in 1992 over concerns about its environmental impact and corruption in connection with land claims and the diversion of scarce water. Yet, the protests intensified in 1996 and in 1997 also human rights violations by local authorities against protesters became a severe problem. Critics charged that the power plant threatened the local environment and did not adhere to governmental environmental standards. Protesters rushed into the streets to support demands for changes in the plant's design and, more broadly, to oppose the Indian government's economic liberalization policies.

Predictably, Enron denied any wrongdoing. However, the harmony in the communities of the plant area and its surroundings was gone and the pressure from the activists' and environmental groups' side could not be neglected or ignored anymore. Thus, the project faced terrible publicity, tremendous pressure to change its practices and intensive scrutiny of actions, which eventually contributed to other risks and finally to delays in project completion.

Human rights risk

The Dabhol project was approved without adequate study of economic, environmental and social consequences. Moreover, Enron and the government of Maharashtra repeatedly ignored public complaints. With the government consistently failing to enforce human rights standards, local nongovernmental organizations, including the National Alliance for People's Movements (NAMP), formed to protest the Dabhol Power project.

To make matters worse, those perceived as protest leaders were repeatedly harassed, both physically and through abuse of the law, as well as arbitrarily arrested and ill-treated. Also, Amnesty International accused the police and security forces of being in "collusion" with Enron. DPC benefited directly from an official policy of suppressing dissent through misuse of the law, harassment of anti-Enron protest leaders and prominent environmental activists, and the police practices ranging from arbitrary to brutal. Furthermore, the company did not speak out about human rights violations and chose to dismiss them altogether.

Because of the continuous dismissal of human rights and Enron's aggressive lobbying on behalf of the three U.S.-based companies developing the project, Enron became widely accused of arrogance and lack of transparency. Thus, the public was vigorously trying to appoint the obvious guilty parties and put them accountable for their actions.

Phase 1 political risk insurance and loan guarantees (approximately \$100 million) came from the U.S. government's Overseas Private Investment Corporation (OPIC). OPIC is prohibited by statute from supporting projects that contribute to violations of internationally recognized worker rights. Thus, the insurance agreements require the investor to respect these rights and OPIC systematically monitored investor compliance with U.S. economic, environmental, worker rights and corrupt practices. Hence, the fact that non-compliance of the rules would constitute a default under OPIC insurance contracts and loan guarantees, induced serious risks to the project and its completion in orderly manner.

¹ Human Rights Watch [referred to 16.3.2002] Available in www format: <URL: <http://www.hrw.org/reports/1999/enron/enron3-0.htm>>

Assignment

Finally, Human Rights Watch called on the actors involved in the project – the government of Maharashtra and India, the Enron Corporation, the government of the United States and public and private financiers – to take concrete measures to investigate and punish the perpetrators of these violations, to take specific measures to ensure that human rights protections would be integrated into project development and to prevent further neglect of standards and rulings.

Resulting from all the bad will generated by public protests and general disapproval, DPC ended up in situation where activist organizations' as well as public authorities' pressure brought about serious uncertainty of the timely completion of the project. Moreover, possible damages payable to the suffered people and communities were threatening the finances of the project.

Political risks

In the Dabhol case the political risk consisted of a changing political environment (new state government, which caused the original deal to be cancelled), bureaucratic, inefficient and slow-moving administration of the state, and constant re-examinations of the project and conflicts over the approved contract terms, especially the prices. All this would cause the project to become a spiralling disaster. MSEB would not pay, and this would cause DPC to halt production and seek for arbitration, finally causing problems and losses to all parties concerned.

The reforms started in the summer of 1991 aimed at making the Indian economy efficient and fast growing, which required competition. Thus, domestic deregulation took place to enhance domestic competition. Trade liberalization, in turn, was to provide international competition. Also public sector emphasis was reduced. The probability of inefficiency in the public sector is high because of political interference and the difficulty of staying in the limits of a tight budget. Therefore, the reform strategy aimed at public sector reforms, privatisation, and a decrease in the fiscal deficit through lowering the public investment.

In an effort to get private investment to fill the infrastructure needs, the Government of India opened up the power sector to foreign private plants. They would help to avoid power shortages and power cuts, which lead to inadequate capacity utilization and unproductive expenditures on back up machines etc., and through that restrict economic growth. Massive investments were also called for because of the rapidly increasing electricity demand in India.

Enron's strategy was to enter into a joint venture arrangement with the Indian government because of the government's refusal to let Enron have a wholly owned subsidiary. In the beginning by all accounts, Enron was in an enviable position. Their joint venture partners should have given them the insider's view of India. With the government a part of the new organisation, DPC, the company should have been the perfect blend of Enron's technology and Indian market know-how.

At first, the whole case seemed fairly clear cut. DPC had an MOU, backed by a number of clearances, which was legally binding. Admittedly, the Indian government at the time did bend several investment rules to get a major foreign investor to come to the country. The central government had given the counter-guarantee in favour of the company. Enron was the first foreign company to receive a government guarantee in India. The guarantees are offered to select foreign investors to enhance their comfort level, partly because of the poor financial condition of state-run companies in infrastructure sectors, such as the state electricity boards. Furthermore, India was suffering from power shortage.

The political risks were first realized as the changing political economy had a critical impact on Enron's situation. The first deal was criticized for lack of transparency, its projected high costs, and potential environmental impacts. The Bharatiya Janata Party/Shiv Sena exploited the sense of unease in the people about the Enron deal and made it a part of their election to throw out Enron. As soon as they came into power in 1995, they cancelled the deal, even though the construction had been started. However, if Enron had been completely thrown out, an alternative supply of power would have had to be provided with a cost cheaper than Enron's. Thus, a new, more advantageous deal for MSEB was negotiated to show the people that the new government was better than the previous one.

Enron's decision to continue with the project work was legally valid, and had in essence nothing to do with the politics. However, the critical factor was that Enron had to give due consideration to its primary customer, the state government. They had to negotiate the PPA with its customer and also maintain relations and build its image for its future deals in the country. The problems arose since it failed essentially to notice that power and politics permeate deals with the governments. India is known for its political instability, which will eventually have a strong effect on the outcome of the project.

Assignment

Enron's reaction has been to invoke guarantees to recover the dues extended by the central and Maharashtra governments to Dabhol. Enron gave the state government a legal notice that it would pursue arbitration in London to seek compensation for the costs incurred, the remobilization of the contracts and the banks, and the interest on the bank debt already disbursed and tried to negotiating with the government about the restructuring the project. The government stalled and MSEB rescinded the power contract in May 2001, saying it could no longer buy Dabhol's power. Enron halted the second phase of the project, issued a notice to terminate the Dabhol contract and named the price it wanted for its equity in the company. While Indian and foreign lenders would have been willing to help DPC produce more cheaply, the threat of legal action existed since the stand-off between the government and DPC continued to jeopardize the project.

In October 2001 Enron offered to sell its equity in the project to the government for \$1 billion on a no-profit, no-loss basis. However, the Indian government refused to allow any state-owned company to buy a stake in Dabhol. Furthermore, MSEB that had defaulted the payments claimed that it could not afford the prices negotiated in the contract. The original deal included a government guarantee to cover any payment shortfall, but they were never met. Later, due to the amounting financial problems and India's slow-moving bureaucrats, Enron would have to accept selling its equity with a clear discount.

The effects on the Indian economy

In India there is chaos on the policy front – projects are pushed ahead without any set standards and criteria, which are needed for the efficient appraisal of projects. Furthermore, different people's organizations are increasingly resisting the projects. Further investigations of the viability of the power project were taken constantly because of the high tariffs and the financial strain. More pressure to review the project was served to the state's coalition government from its political constituents. The result of the Dabhol case was that both sides lost precious time because of political posturing.

Despite local finance, the Indian government has had difficulties getting larger projects off the ground. It is not willing to provide further financial guarantees for large proposals. Such payment guarantees discourage reforms by letting the state officials think they can get additional power without reforms in their electricity boards. Instead, the government intends to promote small plants to supply single customers.

How the problems related to the political risk could have been avoided

By including the government in the deal in order to gain access to the Indian market the venture kept a potential threat close to it. As government has a stake in the venture, they should have done everything to keep it afloat. Unfortunately for Enron, their partner's other interests got in the way.

Questions that arise for the case are whether Enron was fully aware of the financial credibility of India in the international market, whether they had considered alternative sources of financing and the problems with the feasibility report that Enron originally used (a report for the World Bank revealed doubts about it).

The problem could have been solved if the central government would have allowed its own utilities like the Power Trading Corporation to buy power from Dabhol, so that it could have reduced its dependence on MSEB. However, central utilities were as reluctant to buy high cost power as MSEB.

Possibilities for Enron in avoiding the political risks in the first place are involving the World Bank, the Inter-American Development Bank or some other multilateral financing agency in the project more strongly by borrowing from them, through thorough gauging of the environment and political situation and adapting to the circumstances. The arrangements with the host country government were not sufficient to reduce substantially, or even eliminate, the political risk. The secrecy of the PPA creates conflicts with the deals with the politicians that are elected democratically. Thus communication and transparency are critical for the success of a project.

However, there were several problems on the customer's side. Solutions could be making SEBs commercially autonomous, profit-seeking bodies, making reforms in their political economy and guidelines, promoting competition to get better deals by changing the mind-set – invite competitive bids only for the price of power and letting private plant operators sell power directly to customers.

Economical risks

Commercial risk

The Maharashtra State Electricity Board is the sole purchaser of the DPC's product - electricity. To mitigate the commercial risk DPC needed to sign a very binding power purchase agreement (PPA) with its customer. The first Power Purchase Agreement was signed between the DPC and MSEB on 8th December 1993. The PPA was renegotiated after the newly elected Maharashtra state government scrapped the agreement in second quarter 1995. Revised 20 year agreement was signed in November 1995 with final capacity of 2,184 MW implemented in two phases, the first being 740 MW. At the time of signing the average cost of power was calculated to be around Rs 2,4 per kWh produced assuming 90% load.

The PPA was formulated as take-or-pay deal in forcing the MSEB to buy or pay for 90% of the power DPC is able to produce. DPC was to receive capacity availability payments fixed with USD exchange rate plus variable fee for actual energy produced. In case of arbitration the court of London was to be used. PPA liabilities were guaranteed by the owner of MSEB, the State of Maharashtra, counter-guarantees were also provided by the Government of India.

The first defaults to the PPA occurred when MSEB announced 8th January 2001 that it did not have money to pay the bills due from October and November purchases worth hefty \$61 Mio. Dabhol invoked the Maharashtra's counter guarantee to recover the outstanding monthly bills. As the GoM did not honour the invocation DPC invoked Government of India's counter guarantee with equal success. Dabhol left the GoI an arbitration notice and invoked political Force Majeure a month later.

The power purchase agreement was generally critiqued to be extremely expensive for the MSEB. During 1999-2000 it bought 3 870 GWh from DPC at a cost of roughly Rs 4,12/kWh. At the same time the MSEB bought the 9 257 GWh from National Thermal Corporation at a cost of about Rs 1,41. Dabhol's opponents argued that the high rates bankrupted the MSEB, but actually the plant served only about 7% of the total purchased by the MSEB. The high unit cost of power was explained by little consumption as then the amount of fixed capacity charges is dominant and by the inflation of the rupee when some of the charges were tied to the US Dollar.

The power purchase contract itself was very rigorously designed and was supposed to give the Dabhol decent commercial risk cover. It however failed to take into account the possibility of the tariff hike to exceed the solvency of the buyer, which was not able to transfer the cost escalation to its customers or even the public opinion effects of the high prices. Guarantees offered by parties having rather limited resources did not correct the situation as planned but initiated rather harsh countermeasures. There has not been any further consensus between the PPA parties after invoking the first counter guarantee.

Currency risk

PPA effectively transferred the currency risk from DPC to MSEB because most of the payments were tied to the USD and they were thus not influenced by the fluctuations in the currency market.

Mitigating economical risks

Rigid contractual framework dealt with most of the commercial risks adequately. Failures in invoking guarantees can be considered more as legal or political than as economical risks. However the failure of MSEB, the customer, is part of the commercial risk – there is no solvent customer.

DPC could have dealt with MSEB liquidity risk by for example negotiating the PPA to include clauses giving DPC right to sell all excess electricity to other customers. As Enron has considerable knowledge in operating in the energy business it probably has skills needed by the MSEB's operative management. Enron could have demanded a position in the MSEB or at least required it to regularly give status report and give some means of influence or clauses of required financial status of the customer. By these arrangements the Enron could have ensured its customer's ability to pay bills and ask for more.

Technology risks

The first 740 MW phase of the project was a combined cycle naphtha fired plant. Liquefied Natural Gas (LNG) was chosen for the second phase fuel. The Dabhol was to establish its own LNG supply with generous excess capacity.

Technology risks were considered minor as one of the equity investors Bechtel had vast experience of several power and LNG projects. As expected the project did not suffer any major technological difficulties during construction and initial operations. After the debate over due bills arose in the beginning of the year 2001 MSEB slapped a legal notice in May to DPC for defaulting the power purchase agreement. MSEB accused that the plant failed to supply its base load capacity in three hours from request on 28.1, 13.2, and 29.3.

Although DPC admitted that it could not ramp-up from full stop or even from idle to base load in three hours the legal notice should be considered more as a counter measure to DPC's invocations of counter guarantees earlier same year. MSEB stated that the penalty of about Rs 4 billion should pay off its outstanding bills from the end of the year 2000.

Technology risks could have been dealt with the allowance to sell excess capacity to other customers. As there's power shortage in India, the plant would not have to ramp down to idle during MSEB's off-peaks. Switching from customer to another a running plant does not take hours as spinning from idle to baseload does even if some ramp up is required.

Legal risks

Memorandum of Understanding

The Memorandum of Understanding, made on 20th June 1992 for a plant "with a minimum capacity of 2000 MW, includes several conflicts with Indian law. These conflicts impose legal risks on the power project that could have been avoided by taking the local law properly in account.

According to MoU, Enron has to be paid the same amount regardless of the Maharashtra State Electricity Board's consumption of energy i.e. MSEB had to pay for energy produced by 90% capacity of the power plant even though it's consumption would correspond a minor capacity. On the other hand, the Indian law states that a power company can enter into a contract only to sell the electricity that it actually generates and not its generating capacity. The existing norms and parameters are notified by the Indian Government under Section 43 A(2) of the Electricity (Supply) Act, 1948. The price (USD 0.073/kWh) was denominated in US dollars, which is also a departure from the Indian norms.

In addition, the Indian law states that the price that the public pays for electricity must follow least-cost approach. The Indian Electricity Act mandated the Central Electricity Authority (CEA) to conduct a critical examination and give its approval of the technical and economic aspects of all power plants in August 1993. The CEA study showed reasonable capital costs for the Enron plant to be Rs 19.1 million per MW. Enron's estimate was Rs. 44.9 million per MW. Also according to the World Bank's statement, the project is not part of the least cost sequence for Maharashtra power development. Using local coal and gas resources would be a more economical option for Maharashtra power generation.

The MoU has also been claimed to be a one-sided contract by the public opposition of the project and the World Bank. The public opposition states that such a large project ought to have had tenders and the project had been agreed in secret negotiations. On 19 Aug 1994, the High Court ruled that none of these accusations were justified.

Indian law limits the return on equity (ROE) of power generating companies to 16%. However, this law was changed, by adding five words to it, allowing 31% ROE.

PPA

There were some shortages in the Power Purchase Agreement (PPA) made between Dabhol Power Corporation and MSEB. According to Enron's opponents the PPA leaves MSEB's financial liabilities unclear. However this has not yet been a successful argument in courts. The breakdown of project costs and many financial parameters were not defined and all the figures in PPA were estimations. Because of the unclear nature of PPA and other considerations, DPC have been accused of frauds and misleading.

There were also many conflicts between the PPA and the Indian Electricity Supply Act (ESA) law e.g. the application of English Law by Indian parties in respect of an Indian cause of action is claimed to be illegal according to Indian law. The possible conflicts are considered to be in the sections 18, 29, 30 and 43A of ESA.

Enron and corruption

Right from the beginning, the project contract was questionable. The initial contract of the project was considered to be suspiciously generous to DPC. Dabhol has been accused of corruption in the setting up of the project and in the procedure regarding granting official clearance for the project. The World Bank has called this type of corruption “state capture”. The US Government carried out an investigation about the questionable USD 6 million education expenses used by DPC. However, the results showed that there was no bribery involved in the amount.

Enron and DPC have also been criticised about its accounting and auditing procedures. Arthur Andersen is accused of allowing Enron to hide huge losses off the balance sheet. The auditors allegedly conspired in the manipulation of accounts. Despite of this, no cases of prosecution have been made. Generally Enron has a bad reputation in its corporate culture. According to a senator there is an “almost a culture of corporate corruption” in Enron, e.g. the employees have told later that communicating the corruption to managers would possibly have caused reprisal.

CURRENT STATE OF THE DPC

Today the first phase of the power plant is idle and the second phase remains incomplete. Now since Enron's collapse the Indian institutions that financed the plant are trying to negotiate the sale of Enron's interest in the project and the deadline for the bids is on April 15 2002. There have already been some companies announcing that they are considering investing in the project, one of them is Gaz the France. The price however must come down a lot, and the purchase agreement will have to be changed before anyone can go on with the project. Some serious recovery procedures must be done to re-enable MSEB to pay its bills. MSEB is considering selling some of its assets, but it will not be ready in the middle of April in any case. The price of the power also has to decrease by roughly two thirds to be competitive in the Indian energy market.

A lot has to happen before it makes sense to go on with the project, but things have already been done and more is underway. The fact that the Bush-administration are now trying to clean up all their interventions into Enron's problems will probably speed things up, but it will still take considerable time before the mess is cleaned up.

CONCLUSIONS

The project was the focus of attention nationally and internationally because of the controversies surrounding the project's suspension. The Dabhol power project's collapse came at an acutely embarrassing time for the Indian government. Internationally, India had been carefully building the confidence and trust of the foreign financiers and companies, as it needed to secure long-term economic growth.

The DPC debacle follows with a number of foreign investors pulling out of India, e.g. Electricite de France and Cogentrix. Also Daewoo, PowerGen and National Power have previously experienced problems in India.

There are numerous reasons that made the project fail discussed in this paper. The points of failure were that the high costs and that MSEB ran out of money, since its financial situation was not evaluated critically enough in the beginning of the project. One other important factor that proved to be dreadful is that although DPC got decisions in court in favour of them, there was no way they could enforce the decisions, so they could not get their money. The law enforcement did not work as it should have which in turn was a result of many different causes.

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