Research

# Genco gain spells discom discomfort

LCs to induce discipline, but may stretch discom financials

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The Ministry of Power has directed all distribution companies (discoms) to open and maintain sufficient letters of credit (LC) as a payment-security mechanism under power purchase agreements (PPAs) signed with generation companies (gencos or generators). The order, dated June 28, 2019, is to be implemented from August.

The measure was taken in the wake of rising discom dues with private generators, which are not getting paid on time for the electricity supplied, despite long-term PPAs. Additionally, generators are required to procure coal from Coal India Ltd on a prepaid basis and make upfront payments to the railways for coal transportation. Thus, in the absence of timely payments from discoms, generators are facing a liquidity mismatch, leading to excessive dependence on borrowed funds and subsequent finance costs.

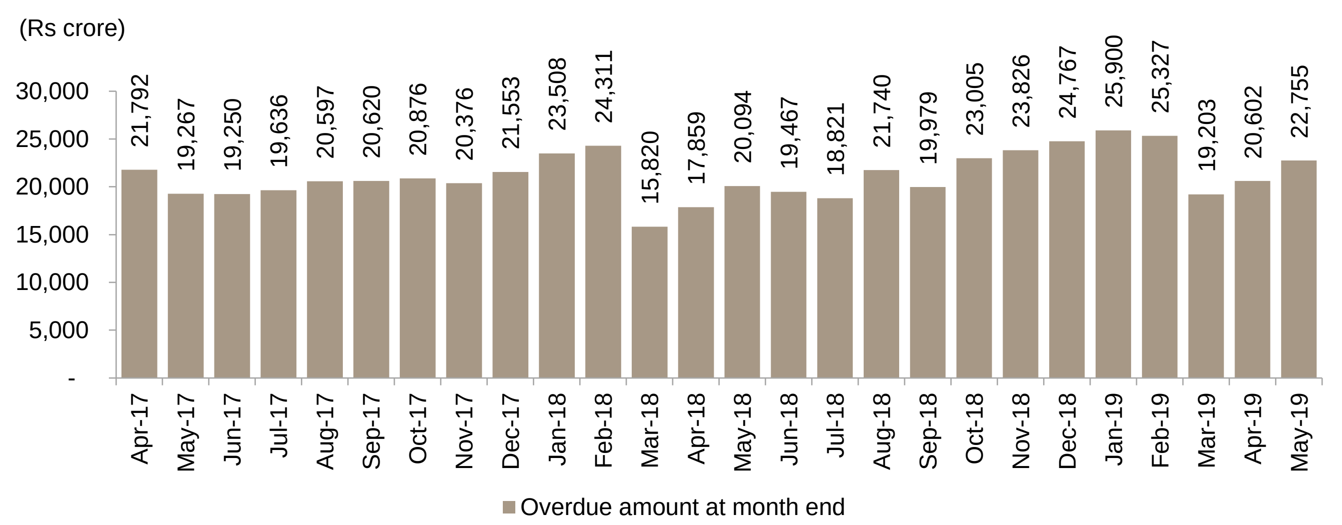
**Highlights of the order**

- Discoms will have to mandatorily provide LCs to the generators against power procurement.
- National and regional load-despatch centres (NLDC/RLDCs) will despatch power from a generator to discom, only when the generator intimates that an LC of required quantum was opened for the specified period.
- The LDC will allow electricity wheeling up to the quantity equivalent to the value of LC, after which the supply will stop.
- The respective genco can encash the LC only after the expiry of the grace period (45 to 60 days), as per PPA terms.
- Even if discoms fail to maintain adequate LC and, hence, are not able to schedule power from their PPA sources, they will not be allowed by the NLDC or RLDCs to procure power from the short-term market.
- Above all, if discoms fail to schedule the agreed quantity of power as per the PPA, they will be liable to pay compensation to generators as per the terms of the PPA.

## Rising receivables from discoms hurting cash flows of gencos

Central and private generators supplying power to discoms under long-term PPAs have been unable to recover dues from discoms, leading to ballooning receivables and stress, and a stretched working-capital cycle. The problem is aggravated by the requirement of upfront payments to be made to Coal India Ltd and the railways for supply of coal for power generation. As per data available on the government portal for “Payment Ratification and Analysis in Power Procurement for bringing in Transparency in Invoicing of generators” (PRAAPTI), the average monthly overdue of discoms towards these generators in the two years through May 2019 was Rs 21,200 crore.

**Average monthly overdue (beyond 60 days) of discoms**

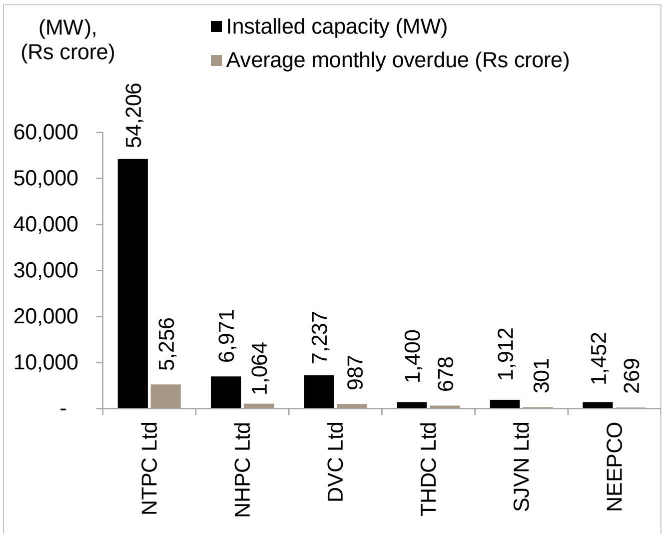



*Source: PRAAPTI portal*

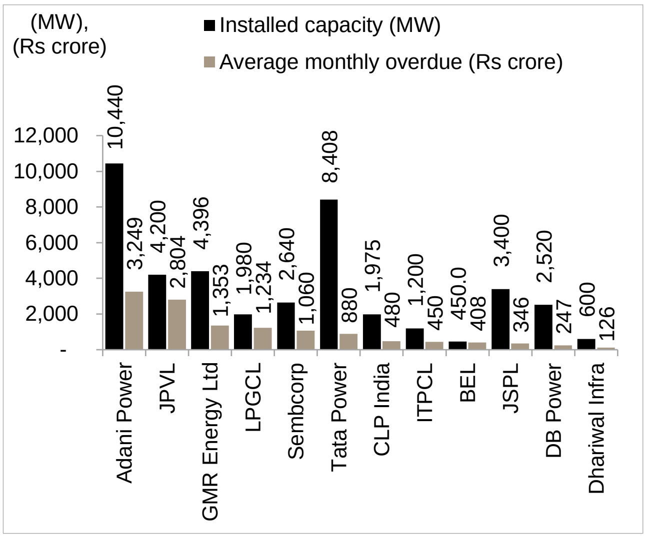
About 18 generators (6 central and 12 private) with a total conventional capacity of ~115 GW tied up with various state discoms across the country report their monthly billed amount on the portal for tracking and transparency. NTPC Ltd, which has ~54 GW of operational power-generation capacity, has the largest share in overdue from various discoms. Among private gencos, Adani Power, which operates ~10 GW of generation assets in the country and supplies power to different states, has Rs 3,200 crore overdue from discoms.

## Genco-wise installed capacity and monthly average discom overdues

**NTPC accounts for 61% of overdues to central gencos and Adani Power ~26% to private gencos**




*Source: Company reports, PRAAPTI portal*



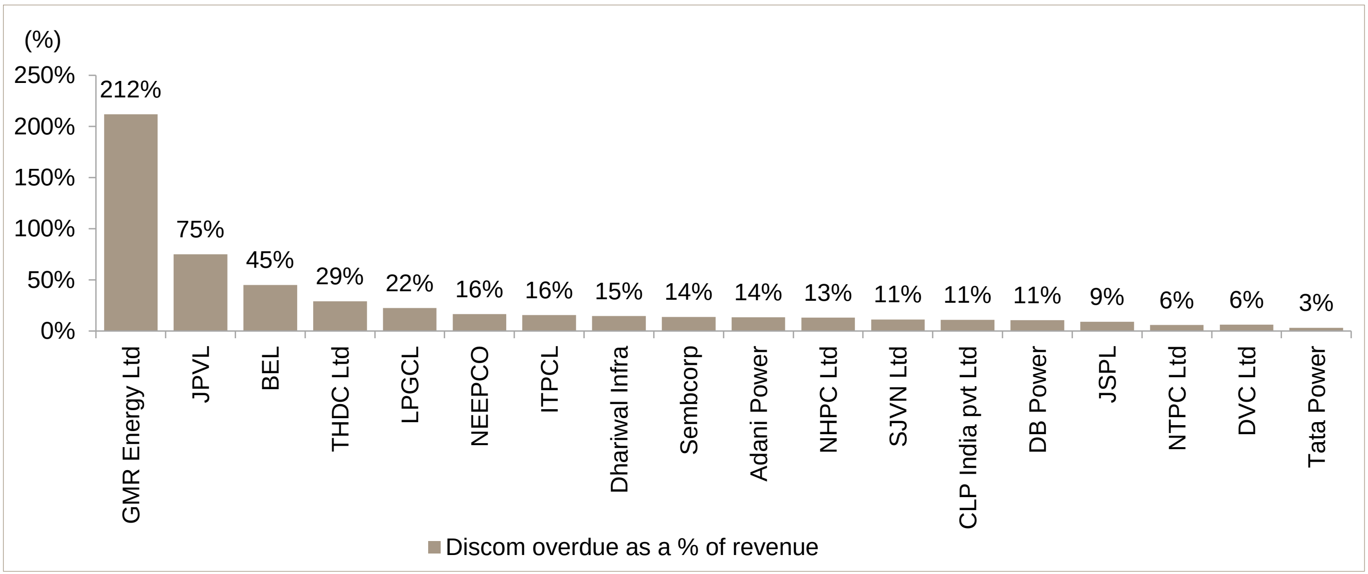

*Source: Company reports, PRAAPTI portal*

## Beneficial for gencos

The implementation of the order is set to benefit generators, as the power supplied to discoms is conditional upon the opening of an LC for an amount adequate to cover the entire quantum of power to be supplied. Once an LC is opened, it will be communicated to the National Load Despatch Centre (NLDC) or Regional Load Despatch Centres (RLDC), enabling generators recover any overdue amount by invoking the LC when a discom does not pay on time.

Inordinate delays by discoms to clear dues has led to financial stress among some private generators, for whom receivables have been bloating over the past two years.

**Monthly average discom overdue, as a percentage of annual revenues of gencos**




*Note: (i) JPVL: Jaypee Power Ventures Ltd, BEL: Bajaj Energy Ltd, LPGCL: Lalitpur Power Generation Company Ltd, NEEPCO: North Eastern Electric Power Corporation Ltd, ITPCL: IL&FS Tamil Nadu Power Company Ltd, JSPL: Jindal Steel and Power Ltd*

*(ii) Revenue numbers are based on the latest financial information available for each entity. For GMR Energy, revenue is the consolidated energy business revenue of GMR Infra for fiscal 2019, according to the company's presentation to investors*

*Source: Company reports, PRAAPTI portal, CRISIL Research*

After the implementation of the order, generators are expected to get payments within the expiry of the official credit period (i.e. 45-60 days, as per the PPA terms). This should curtail the piling-up of overdue from discoms and help generators procure coal on time. Additionally, generators do not have to either resort to a shut-down and forego revenue or depend on expensive external borrowings, as a deterioration in the credit profiles of generation players has led to higher interest rates from banks on their loans.

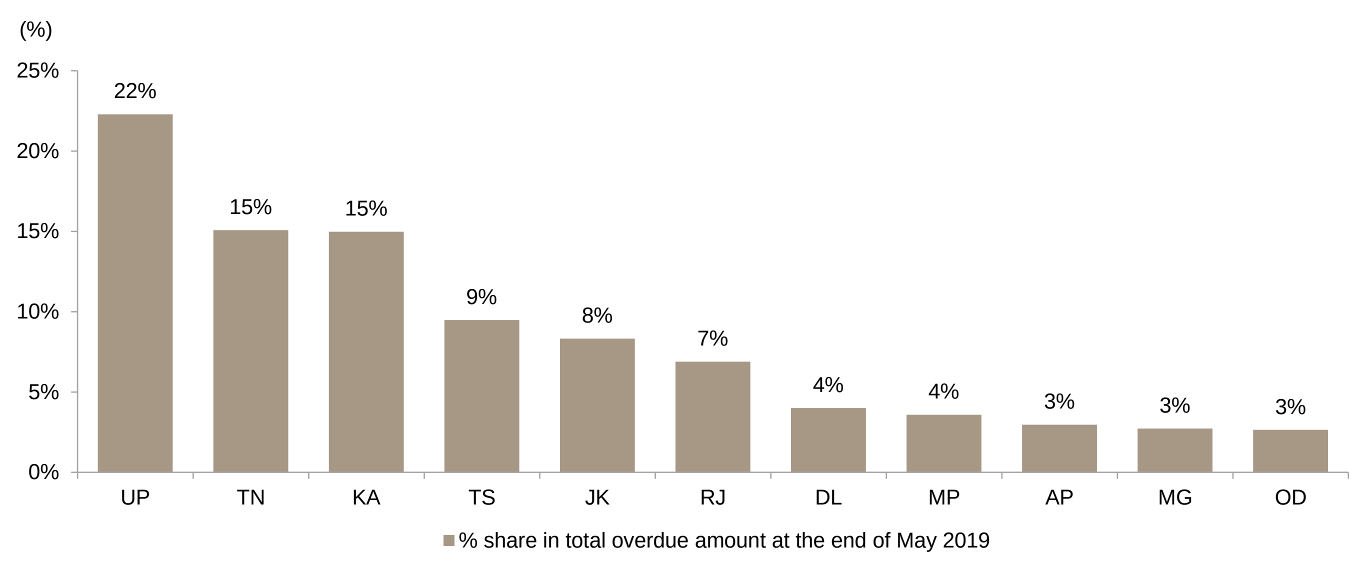
However, the issue does not end here, because the order does not mention a resolution mechanism for the already outstanding amount from discoms at the end of May 2019, in addition to the amount that will aggregate until the time of the order's enforcement. Thus, the recovery of overdue (including the outstanding that has not yet become overdue as on date) will be challenging for generators, as discoms may defer these payments looking at the additional burden of complying with the LC mechanism.

In conclusion, while the accumulation of discom overdue towards gencos is set to decline after the implementation of the order – provided the discoms comply with the LC mechanism – recovery of existing dues will remain a drag on the financials of gencos.

## All is NOT well for discoms

Delaying payments to generators has helped discoms manage their working-capital cycles, meet short-term obligations and avoid costly working-capital loans. However, once the LC mechanism is implemented, discoms will be forced to pay their outstanding bills against power purchases, as failure to do so could result in invocation of the LCs given by them.

**A snapshot of state discom-wise share in total overdue**




*Note: UP: Uttar Pradesh, TN: Tamil Nadu, KA: Karnataka, TS: Telangana, JK: Jammu and Kashmir, RJ: Rajasthan, DL: Delhi, MP: Madhya Pradesh, AP: Andhra Pradesh, MG: Meghalaya, OD: Odisha*

*Source: PRAAPTI portal*

Some state discoms, such as those of Uttar Pradesh, Karnataka, Tamil Nadu and Telangana, have delayed payments – equivalent to 3-5 months of the power-purchase cost – to the central and state gencos *(Source: PRAAPTI portal)*.

This extra working-capital cushion, leveraged extensively by discoms, will not be available now, compelling discoms to raise additional funds either through internal accrual or state-government support in terms of grants or bank borrowings to finance operations.

Alternatively, discoms will be forced to undertake load-shedding when requisite generation is not available. But then, load-shedding or power cuts are going to be penalised, as the government is coming out with stringent norms to this effect.

As per the order, discoms will have to provide LCs equivalent to their monthly power-purchase bills. This will be a herculean task for many discoms, given their precarious financial positions. The following table shows the estimated monthly LC requirement and current overdue for some key discoms.

**Tentative LC requirement and overdue for key states (as of May 2019)**

| State | Average monthly bills raised/LC required (Rs crore) | Outstanding payable (Rs crore) | Overdue payable (> 60 days) (Rs crore) | Equivalent of power purchase (in months) |
|---|---|---|---|---|
| **Uttar Pradesh** | 1,390 | 6,420 | 4,980 | 3.6 |
| **Karnataka** | 710 | 4,460 | 3,380 | 4.7 |
| **Tamil Nadu** | 770 | 5,290 | 3,370 | 4.4 |
| **Telangana** | 620 | 3,470 | 2,120 | 3.4 |

*Source: PRAAPTI portal, CRISIL Research*

## Compliance with LC mechanism to hurt discoms, consumers and states

The LC mechanism will put additional financial burden on discoms in two ways.

First, it will shorten the prolonged credit periods that discoms have enjoyed by deferring dues to generators, leading to a rise in working-capital requirement for their operations. CRISIL Research estimates that additional working capital requirements may lead to a further rise in interest burden of Rs 400-500 crore for the above-mentioned state utilities and of Rs 2,500-3,000 crore across all state distribution utilities on an annual basis[1].

Secondly, it will lead to increased financial charges for implementing regular LCs.

Hence, some options available for discoms are:

- Debt in the form of additional loans from commercial banks, issuance of commercial paper
- State support in terms of grants or early release of subsidies

State support, either in the form of grants or subsidy disbursals, may be difficult, as the states mentioned above, which are leading in overdue, have also reported high state fiscal deficits. The gross fiscal deficit (GFD) for all of these – Telangana (3.5%), Uttar Pradesh (3.0%), Karnataka (2.9%) and Tamil Nadu (2.8%) – is above the average GFD of 2.6%[2], lowering the probability of any significant or prompt support from the state governments.

That leaves discoms to depend on bank borrowings to meet LC requirements, resulting in a further rise in debt and consequently, further increase in interest costs. This may goad discoms to consumers for recovery, either through tariff hikes or creation of regulatory assets that enable recovery of carrying costs through tariffs in subsequent periods.

If the NLDC or RLDCs reject power scheduling from inter-state generating stations without the provision of LCs, discoms may continue to schedule power through central and state-generating units, and may instead refuse to open LCs against power procurement from private sources and/or opt for partial load-shedding.

[1] *Additional working-capital requirements are due to the shortening of credit periods earlier available to discoms due to deferred payments. The average monthly overdue over fiscal 2017 to fiscal 2019 comes out to be Rs 3,500 crore for the four state discoms mentioned and to Rs 21,100 crore for all state discoms [Source: PRAAPTI portal], on which a working-capital loan interest rate of 12-14% has been applied to arrive at a annual interest burden of Rs 400-500 crore and Rs 2,500-3,000 crore on additional working capital needs, respectively.*

[2] *Fiscal deficit for the states as mentioned above refers to the gross fiscal deficit as a % of the gross state domestic product for 2018-19 (budget estimates) as per Reserve Bank of India's study on state finances published in July 2018. Average GFD refers to the average for non-special category states.*

That's because NTPC already has a similar payment-security mechanism in place, and is less likely to be affected by the order. Similarly, states have a substantial portion of installed capacity under state-generation arms (which are currently under-utilised; all state-owned plants were operating at an average ~58% plant-load factor in fiscal 2019), which may be ramped up to partially meet demand, enabling the state to not having to depend prominently on inter-state sources. Intra-state scheduling of power comes under state LDCs, which are not under the purview of the above order, as they are a part of state jurisdiction.

However, even after ramping up central and state sources, discoms may face average base energy shortage of ~15-20% at the all-India level, which they will have to buy from private entities. Further, ramping up of state and central generating sources will be subject to various constraints such as coal availability, grid balancing requirements and merit order dispatches, and may compel discoms to depend on private power.

Consequently, this mechanism may lead to a further rise in debt levels for discoms in the absence of state support. Additionally, discoms may resort to increasing offtake from central and state stations as much as possible, which may result in lower offtake from private generators.

## A bold step, but structural reforms needed

Though stricter enforcement of the order will engender discipline among discoms, structural issues persist and states need to take hard decisions and reforms to support its discoms, such as:

- **Tariff hikes:** Inadequate tariff hikes in many states have led to discoms incurring losses and borrowing heavily. In fiscal 2019, only 17 states raised tariffs compared with 22 in fiscal 2018. Further, lower-than-required tariff hikes in many states have led to revenue under-recoveries for discoms that are often converted to regulatory assets to carry forward for subsequent tariff periods. Consequently, the average cost of supply to average revenue realised (ACS-ARR) gap widened to Rs ~0.23 per kWh last fiscal, after declining to Rs 0.18 in fiscal 2018 following the implementation of Ujwal Discom Assurance Yojana (UDAY). To avoid deterioration in discom financials, states need to increase tariffs adequately. Also, consumer category-wise tariffs must be rationalised based on cost of supply to avoid consumer backlash.
- **Reduction in AT&C losses:** Many states failed to achieve their AT&C loss-reduction targets set under UDAY, due to poor implementation of reforms and lower investments in distribution infrastructure. AT&C losses, which measures operational efficiency, have narrowed from ~23% in fiscal 2016 to ~19% at the end of fiscal 2019, but remain higher than the target of ~15% set under UDAY for March 2019. States must make relentless attempts to ensure discoms achieve their loss reduction milestones in a timely manner.
- **Distribution-infrastructure investments:** Apart from central government-sponsored schemes, investments by discoms and states are necessary to strengthen the distribution infrastructure and improve systemic efficiency. Almost all discoms are lagging in terms of installation of smart meters (cumulative achievement is just ~4%) targeted under UDAY to stop pilferage/theft and improve billing and collection efficiency.
- **Evolving business models in power distribution:** The distribution segment needs alternative business models based on increasing competition. Some reforms in the Electricity Act, 2003, such as the introduction of private participation through distribution licences, franchisee model with proviso for infrastructure investments, and commensurate returns for investors need to be promoted to improve the distribution sector.

To conclude, while ensuring payments to generators is the right step, lack of wherewithal of discoms could impede smoother implementation and worsen the situation of already-weak state utilities.

A more sustainable solution to the problem of delayed payments to generators would require reformative action from states in terms of regular and sufficient tariff hikes in tune with cost of power supply, phasing out subsidisation, reduction in AT&C losses, and improvement in operational performance.

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