Counterparty Challenges Forcing Renewables to Run Out of Energy

Sponsor Support and Structural Strength Provide a Cushion

Special Report

Liquidity Strain Stems from Payment Delays: State power utilities' (major power purchasers) insensitivity to projects' debt service commitments and delays in making payments - problems specific to conventional energy developers – are now plaguing renewable energy projects, says India Ratings and Research (Ind-Ra). The central government's initiative - Ujwal Discom Assurance Yojana (UDAY) - aims to lessen the cash flow strain on power distribution companies through the transfer of debt loads to states. However, before all states implement the scheme, the projects are compelled to tide over the elevated liquidity strain in the interim.

Dire Need to Nurture Capital Market Instruments: Although several renewable energy projects are embarking on capital market transactions, the counterparties' insensitivity to the projects would not only jeopardise the potential issuances that can help deepen the infra-debt markets, but also add a premium, which has become an accepted practice for renewable energy projects. Counterparties' timely payments are inevitable to nurture the nascent non-recourse capital market debt instruments.

Skewed Risk-Return Relationship: The financial weakness of distribution companies in general is a fact. Although their obligations towards power purchase are considered senior to their debt commitments, many counterparties delay payments beyond six months. The debt market factors this aspect in the pricing of these issuances needlessly skewing the risk-return relationship, especially at a time when the government has mega plans for renewable energy projects and is aiming at grid parity between thermal and renewable energy projects.

In many cases, the credit profile of renewable energy projects is constrained by the weak financial health of the counterparties rather than operational and supply related risks. The risks in these cases are manifested in the form of uncertainties relative to the timings of receipt of payments for power purchases more than the delays. Therefore, this uncertainty is factored into the pricing of infra bonds, causing a burden on the projects' cash flows. The agency believes this would not have been considered by bidders while quoting an aggressive tariff for bid based projects. In other words, the financial costs of counterparties are being subsidised using project cash flows which will cause a heavy damage to the capital markets in the longer run. It also strips the equity holders of their returns, resulting in a disincentive to embark on more such renewable energy projects.

Central Government's Initiatives Challenged: Any event of default on the capital market instruments or invocation of a security/credit enhancement would have an adverse impact on the federal government's hard work and effort in building and deepening infra bond markets. Such an untoward event not only will derail the efforts to diversify and derisk the predominant bank loan market; but also could hamper the government's efforts by vitiating spreads in the much-sensitive masala bond markets and the dollar bond borrowings by Indian companies. Infrastructure investment trusts and their capital raising plans could also take a beating.

On one hand, the government of India has been implementing various measures to build an effective infra-debt market. On the other hand, the energy distribution companies exhibit a callous attitude in honouring their obligations towards power purchase in a timely manner. Unless discoms understand the importance of timeliness, which is crucial for the survival of the bond market, the government's initiatives will remain challenged.

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Weakening Standalone Profile: Unpredictable counterparty behaviour will cause a strain on those project developers that have ventured into the uncharted territory of the bond market considering the receivable period of the counterparty at the time of issuance, along with an implicit assumption that the receivable days will remain stable. Although the bond structures and conventional bank loans feature a debt service reserve equivalent to three or six months of debt service obligations as a line of defence, the continued strained liquidity could dent projects' standalone credit profile.

During the agency's review of the ratings of renewable energy projects, it was observed that that the Maharashtra State Electricity Distribution Company Limited has delayed payments to wind projects by about a year. Although the direct impact of delayed payments will be apparent on the projects' liquidity, the ultimate impact could be on the investors/lenders if the situation exacerbates. However, the payable days of other discoms remain static compared to the previous years.

Deceptive Historical Receivables Period: Given the reasonable historical payment record of Maharashtra State Electricity Distribution Company, many sponsors failed to anticipate a receivable period of over three to four months. The agency in its rating and stress cases assumes a long delay, however not the kind of delays being actually experienced. Notwithstanding projects' operational strength, debt service could be impaired on a prolonged delay in the payment period from state utilities, should the sponsors fail to support such projects. It is indeed an irony that the federal and state governments have been insisting on the importance of clean energy and placing more importance on market issuances through infrastructure debt funds and infrastructure investment trusts while the counterparty's behaviour is oblivious to and counterproductive of these developments. However, the agency believes that there would be an improvement in the liquidity of distribution companies after UDAY is fully in place.

Figure 1

Snapshot of Payable Days

Payable days	Utilities
Less than 30 days	Gujarat Discoms, Bangalore Electricity Supply Company, Chamundeshwari Electricity Supply Company, Andhra Pradesh Discoms, NTPC Vidyut Vyapar Nigam Limited
30 days to 60 days	Hubli Electricity Supply Company Limited
60 days to 120 days	Haryana and Punjab Discoms
120 days to 240 days	Madhya Pradesh Discoms
More than 240 days	Rajasthan, Maharashtra and Tamil Nadu Discoms

Source: Ind-Ra

State Utilities Payment Record - A Mixed Bag: It is noteworthy that in newly formed states such as Andhra Pradesh and Telangana, state utilities not only pay renewable energy projects on time but also claim the rebate delineated in power purchase agreements. Although the receivable period may vary, Tamil Nadu and Rajasthan state utilities' uneven payment records weigh heavily on the respective projects' risk profile. At FYE16, INR98.96bn worth of UDAY bonds were issued by several states. Ind-Ra expects the impact to be direct but may not be instantaneous, given the state governments' administrative process lags.

No Easy Solution in Hand: One temporary solution could be to prioritise payments for renewable energy projects; but, this does not have a strong rationale and may not help in the longer run. Whatever is the number of days of delay, at least defining these delays in terms of certainty and imposing a soft cap on the receivable days would go a long way towards achieving the government's focus in developing capital markets for infrastructure and in achieving the tall aim of capacity addition in respect of renewable energy projects.

Ind-Ra's rating experience suggests there is no easy solution to the current quandary of Maharashtra-based projects unless prudent practices such as a strong cash reserve or sponsor support are put in place for these projects. A line of working capital credit would certainly help in avoiding delays in debt service; but borrowing a debt to pay off another debt may not be a wise solution. Also, without a certainty regarding the number of months of delay, availing working capital is infructuous. Although a majority of power purchase agreements mentions a letter of credit as a backup for payment delays, it is rarely established by discoms. However, Uttar Pradesh utility in a few thermal power projects has entered into default escrow agreements wherein the revenues from a particular customer segment is escrowed to a default account which is marked to the power generators' escrow accounts. A similar structure in addition to the letter of credit has been proposed by Uttar Pradesh for several renewable projects. After the establishment of an escrow agreement, the receivable days of these projects have reduced substantially.

While the federal government has set ambitious targets in creating new capacities, the projects remain hostage to state utilities' behaviour. This could inflict reputational damages to state utilities that may be difficult to correct, with severe financial and economic consequences for the entire renewable projects ecosystem and the infra debt market. Before state utilities stray further and cause hard landing for renewable energy projects, there is a dire need for them to take a balanced step.