Outlook: Indian Power Sector

THIRD WAVE SOLUTIONS

Vipul Goyal
November 21, 2012

India is one of the biggest rapidly growing countries. Along with it, so is its power sector. Given that there is a power output shortfall, the sector has the potential to grow not only at the rate of GDP growth, but even faster to catch up with the unmet demand. Therefore, investors are naturally excited about the sector. However, demand is not the only factor that governs investor returns. A closer look at the entire power value chain prevents us from sharing the optimism of other investors. In reality, the sector is plagued with problems up and down the chain, which makes us skeptical of the medium term prospects.

Problems as we see them

Power is provided free of cost to the agricultural sector, which sometimes ends up being wasted (and amongst other things leads to water level depletion). Furthermore, we believe that the SEBs (State Electricity Boards) are supplying electricity to retail consumers at rates that do not cover their costs. The reason being: political parities do not wish to incur wrath of millions of voters by raising the electricity price. Collection of money is ineffective and people often get away without paying for the electricity they consume, especially in the remote areas. Pilferage losses also occur due to theft of power caused by illegal tapping of un-insulated lines and rigged/faulty electricity meters.

Furthermore, transmission & distribution losses (of around 25%) are way above the international average of around 10-15%. One reason for this is that long LT (Low tension) wires are used for extending transmission to the rural areas and the technical losses are greater due to the low voltage on these LT wires. As a result of all the problems, SEBs have continued incurring losses and have accumulated huge levels of debt (2.5 lakh crores).

There is a shortage of cash in the whole chain. The SEBs are bankrupt and have no money to pay the power producers. Nor is there money available to invest in the grid, which desperately needs to be upgraded.

We believe that Cash is King. Even though power producers are selling their power, they are doing so on a credit basis. There has been a considerable rise in "Sundry Debtors" – meaning their quality of earnings is not healthy. In short, they are not generating much cash. Reports suggest it takes the producers 9 to 12 months to get their payment from the government. Their woes do not end here. The sector is tightly regulated and the power producers have a restricted ROE (Return on Equity) of around 15% for the years 2009-2014, meaning that their upside is capped but downside is unlimited.

Around 55% of power in India is produced by coal fired power plants. Many power plants in India are running with critically low supplies of coal – often at 25% or less of recommended stock. Furthermore, many power producers are allotted coal blocks at the time of project initiation. But it takes years to obtain permission and clearance to start mining, during which the power producer continues to erect the power plant. In many cases, even though mines are allotted, the right to mine the coal is not given. This suddenly leaves the power producer in a lurch to find coal supply on his own and at his own cost, however more expensive or difficult it may be.

Furthermore, the agreements (PPA) signed in the past were not well negotiated. If the fuel cost increased or fuel supply became limited, the power producer suffered. This is because they were tied to the contract and the power producer failed to consider the risk of rise in coal prices (since they were stable at the time of signing the contract). There have even been cases where the matter was taken to the courts.

Coal India supplies coal to more than 80% power plants in India. It has a monopoly there and is owned by the government. Hence, the government is the supplier of the fuel and also the buyer of the end product. At one end, the government ties their hand for 10-20 years with long term PPAs and on the other, they do not give them rights and supplies to produce the power. Even after the government not giving mining permissions (to some), they allow Coal India to default on their contracts. Now, Coal India commits to supply only 65% of the coal needed.

Changes we would like to see

We feel that in the current scenario, the power producers are being squeezed from both sides – fuel supplies limited/uncertain and cash collection from SEBs limited since SEBs themselves are cash starved.

We believe that coal block allotment should be done on a pre-approved basis: the Ministry of Power should allot the coal mines along with the MOEF's (Ministry of Environment and Forests) permission to mine. This will remove the uncertainty of coal to those who are allotted the mines and make project planning much simpler.

It is our belief that the average price charged for electricity per unit in India is well below what its actual cost it. There is a need to rationalize the tariff. Additionally, the power producers should be allowed to pass on the additional fuel cost to the end users through negotiated PPAs or open market selling.

Currently, the power producers and the grid are both tightly regulated. We believe that a change here is necessary. In the US, the grid is common, but different suppliers of electricity to the grid charge their own price and it is up to the industrial consumer to chose who he wants to buy his electricity from. Regulation on power producers should be loosened up since it is only the grid which is a natural monopoly. The power producers should be allowed to function freely.

There is also a lot of money lost due to T&D (Transmission & Distribution) losses. If strong steps are taken towards reducing them to a minimum, it would have a tremendous impact upon successful implementation. This is a no-brainer since it is a win-win situation for all involved. Research even shows that such projects have a high IRR (Internal rate of return).

Conclusion

All said and done, there are 2 principal problems: collection of cash from consumers and supply of fuel to the power producers.

Any steps taken in the future that lead to elimination of these problems would result in a better outlook for the sector in the long run. But we think that in the short run of 2 years (till 2014) the power producers are going to do badly. Even after 2014, there might not be a considerable change unless cash collection is improved dramatically. Even a SEB bailout will not solve the problem; it is just a temporary solution.