



# Stressed assets conundrum

Will it impede new capacity creation if not addressed well?

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India's lending system has come a long way. 'Stress' was once a taboo word and 'extend and pretend' was the norm when signs of underperformance would show up in loan accounts. Though some ground is still to be covered, lenders today are more open than ever to recognise stress, and initiate efforts to deal with the situation. The banking regulator has facilitated various schemes for financial restructuring of accounts, and has been prodding the lenders to come clean on the extent of the problem.

## Private participation in conventional power:

### A stillborn baby? Is it stagnant?

The power sector has been one of the chief contributors to the INR 10,000 billion<sup>1</sup> of stressed assets in the lending system. While various statistics are rolled out in the market, our own estimates lead us to believe that nearly 50 GW of 70 GW of operational coal power plants in the private sector is stressed. The situation on capacity under construction is a picture far grimmer, and 80 to 90 per cent of those assets may be stressed. Delay in construction may be often used by borrowers as a tool to avoid recognition of the stress.

Private participation in the thermal power sector stands out as 'still born' in what has held out as a promise of an ever-growing and profitable market for the private sector.

The magnitude of the problem is large and augurs poorly for any future private sector participation in conventional power programmes. A reflection of this lies in the fact that the next round of Ultra Mega Power Plants (UMPP) has been delayed incessantly, and the private sector is not considering any significant fresh coal power capacity creation.

Interplay of genuine business environment issues, policy inaction and developer aggression are key causes, which were aided by indiscreet lending to the sector.

1. Reserve Bank of India: Financial Stability Report, Issue No. 13, Deployment of Bank Credit data



Coal-based power, once perceived as a panacea to India's growing and large latent power demand attracted many private sector investors to the sector. The developers are realising now that the playing

field has changed faster than they imagined.

Some key factors, which have led to the present situation, could be summarised as:-

<p>Inadequate power demand, and drying up of Power Purchase Agreement (PPA) pipeline</p>	<ul style="list-style-type: none"> <li>• The latent power demand as was estimated in the grid has not played out. While a part of it is attributable to the long standing intermediation inadequacies of discoms, a large part is the lack of industrial demand pick-up due to global economic slowdown.</li> <li>• Low prevailing prices in energy exchanges have discouraged the discoms from executing any long-term PPAs leading to stranded power plant capacities.</li> <li>• The linkage of fuel availability with PPAs has led to a vicious cycle.</li> <li>• Coal block auction process, which exhorted developers to mine coal only if they could find PPAs has become a death trap as no PPA bids have taken place after the coal auctions.</li> <li>• A renewable energy push, which is arguably non-commensurate with the current demand growth scenario, is further straining existing coal power capacity.</li> </ul>
<p>Inordinate taxation</p>	<ul style="list-style-type: none"> <li>• Multiple rounds of direct/indirect taxation have been introduced on coal power, which has increased the cost of generation. The introduction of clean energy cess, increase in stowing excise duty and other such taxation changes have increased the cost per unit by an estimated INR 0.50-0.70/ KWh.<sup>2</sup></li> <li>• Rather than a rail freight rationalisation, the railways has introduced charges such as busy season surcharge, which is levied nine months in a year, which have further escalated costs by INR 0.30-0.50/ KWh.<sup>2</sup></li> </ul>
<p>Execution delays</p>	<ul style="list-style-type: none"> <li>• Credit appraisal systems of banks were not geared for underwriting execution risk and equity commitment risk of developers.</li> <li>• A large number of projects faced last mile equity constraints, general execution delays leading to time delays and cost overruns.</li> <li>• Developers underestimated the execution challenges and, more often than not, bound themselves to contracts, which did not provide an adjustment for business uncertainties.</li> </ul>
<p>Coal shortages</p>	<ul style="list-style-type: none"> <li>• The government has initiated extensive measures for revitalising coal production in the country. However, rather than introducing a market economy, the coal market is still shackled in PPA-linked coal disbursement and multiple other complex dispensations.</li> </ul>
<p>Protracted dispute resolution</p>	<ul style="list-style-type: none"> <li>• Tariff disputes under PPAs often go into prolonged litigation with eventually most of them landing at the doorstep of the Supreme Court straining interim cash flows of developers.</li> </ul>

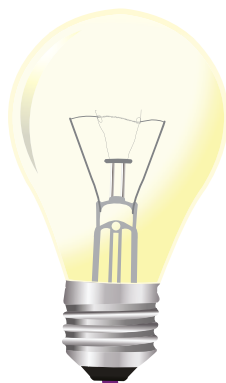
2. KPMG in India analysis

## Uncertainty is the new normal for power business:

### Only agile businesses models to survive

The power sector is in the throes of irreversible trends, which is likely to transform the face of the industry. What these trends would imply is that one-time restructuring/stress resolution windows may not be sufficient, and a more agile approach is warranted:

- The use of renewable energy has become widespread globally, and with the Indian government having signed the COP 21 protocol, we are likely to see more of solar and wind power. This implies that conventional power has to contend with this new normal of reduced plant utilisation.
- Decentralised solar power generation would wean away valuable industrial and commercial customers from the grid, negatively impacting the already weak discoms.
- The advent of economical storage, bundled with energy efficiency, may further accentuate the decentralised generation trend. This would further weaken centralised power generating plants, and large scale renewable energy may also not be able to hide behind the veil of their status as must-run stations.



## All stakeholders should work together to 'make the elephant dance'

Any successful stress resolution has to focus on the core of the problem and a mere deferral of repayment schedules would only cause large future slippages.

We believe that a fundamental shift in the nature of restructuring exercises being undertaken is warranted from an adversarial to a harmonious one:

- The Reserve Bank of India (RBI) has been nimble, and has facilitated various windows like S4A, Strategic Debt Restructuring (SDR), framework for revitalisation of distressed assets, flexible structuring of term loans. The feedback loop of RBI is strong, and it has been tweaking the schemes to better conform to ground realities.
- Lenders more often than not are reluctant to take meaningful debt haircuts leading to further account slippages in future due to asset quality deterioration. Stressed asset funds have ready gunpowder of USD 1.5 billion to USD 2 billion, especially for the power sector, but are often stalled from a swift transaction due to preference of lenders to walk down the long path of exhausting all alternatives before an eventual sale. The sale process, which itself follows an unpredictable journey of a series of reserve price reductions and speculative bidders, has often resulted in failures. Lenders have to seek greater professional advice and be open to negotiated settlements.
- The unstated principle of the promoter losing all equity before lenders taking any debt write-down makes the existing sponsor an adversary, and is more often than not counterproductive. In cases impacted by genuine business environment challenges, lenders need to on-board the existing sponsor and share the losses/gains though the balance could be tilted in favour of debt.
- Protecting asset quality while the loan undergoes a resolution is critical. Lenders need to engage professional asset managers to guide commercial decisions and monitor day-to-day operations to preserve value.

## Government as an active player

Infrastructure creation is perceived as a responsibility of the government, and the private sector invests based on an appropriate risk-reward trade-off offered by it.

Global and local macro conditions and a few on-ground challenges have led to a fundamental imbalance in this promised risk-return metric in conventional power markets and created huge stress. Thus, the Government would need to play a more active role in the resolution of stress.

A new investment cycle would be rekindled only if the existing assets start bearing returns. The Government would need to adopt a more hands on approach and take the role of a leading player to send the right message to future investors in the Indian power sector.

A few levers that the government should consider:

- Renegotiation of existing power sale contracts to cover uncertainties not envisaged earlier shall be considered. Hitherto, regulators have typically avoided any hard decisions.
- A low-hanging fruit can be a swifter resolution of PPA disputes. Regulators shall be pressed for early resolution of tariff petitions as is already stipulated in regulations.
- The government can consider creating open and deregulated coal markets. Coal contracts, supply terms and pricing should be best left for market forces to decide. Commercial mining is the need of hour, and the Government should push for facilitating a framework.

- India is one of the very few energy markets, which tax coal power production indirectly by various cess, surcharges and also on the other hand imposes renewable energy obligations on end customers. There is a case for abolition of clean energy cess as renewable energy is reaching grid parity on its own and may not need any further subsidy support from this corpus.

- On the one hand, domestic coal stocks are mounting, and on other hand we have commissioned projects that await long term fuel supply. Auctions can't be considered as the only solution. The government needs to think of a transparent one time measure to bridge this imbalance.

- The government should initiate measures to decommission older inefficient power plants, which would create demand for more efficient but idling power plants. State Gencos may also consider taking over partially/fully newly constructed efficient power plants under a transparent process, which would also address the commissioned capacity that's stranded only due to lack of PPAs.

- A stressed fund under the aegis of National Investment and Infrastructure Fund (NIIF) managed by professional experts is the need of the hour. Assets taken over by such a fund (under steep discounts) can be offered a resolution around key issues such as fuel, PPA as 'one-time measure'. Once, these projects are on track, they can find multiple suitors.

As Albert Einstein said "We cannot solve our problems by the same level of thinking that created them." We believe that the stakeholders need to rise above the current stress resolution practices and approach the stress in the power sector with an open mind set and implement sustainable bespoke approach.



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