

September 28, 2021

## Mangalore Electricity Supply Company Limited: Rating assigned for enhanced limits and reaffirmed for existing limits

### Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based Term Loan	1150.00	1631.87	[ICRA]BBB+(Stable); Assigned/Reaffirmed
Fund-based Overdraft	500.00	500.00	[ICRA]BBB+(Stable); Reaffirmed
Non-fund-based Letter of Credit	200.00	200.00	[ICRA]A2; Reaffirmed
Unallocated	-	18.13	[ICRA]BBB+ (Stable) / [ICRA]A2; Assigned
<b>Total</b>	<b>1850.00</b>	<b>2350.00</b>	

\*Instrument details are provided in Annexure-1

### Rationale

ICRA's rating takes into consideration the 100% ownership of Mangalore Electricity Supply Company Limited (MESCOM/the company) by the Government of Karnataka (GoK), its strategic importance to the state power sector and the monopolistic nature of business supported by cost-plus tariff-based principles. The ratings continue to derive support from the healthy operating efficiency of MESCOM, as reflected by the relatively low distribution loss levels of 10.07% in FY2020 and 9.86% in FY2021 (provisional). The ratings also factor in the established regulatory process in the state, evident from the presence of the multi-year tariff (MYT) regime, the regular issuance of tariff orders with upward tariff revision and the annual true-up of the actual performance of the distribution companies (discoms). ICRA notes that the tariff order for FY2022 was issued in June 2021, with an approved tariff hike of 3.84%, including the true-up for FY2020. Further, the rating draws comfort from the considerable cash inflows of MESCOM from consumer contributions and grants towards capital assets, equity infusion from the GoK and security deposits from consumers.

The ratings, however, remain constrained by the vulnerability of MESCOM's power purchase cost (PPC) to the overall power-procurement mix and in particular, to the proportion of power sourced from hydel stations of Karnataka Power Corporation Limited (KPCL); any shortfall in these stations could lead to dependence on high-cost power, as seen in the past. Also, increased procurement of renewable power in the power purchase mix of MESCOM in recent years has led to backing down of long-term thermal stations, wherein the discom would continue to pay the fixed charges, which in turn could lead to increase in PPC per unit. This is further accentuated by the company's inability to pass on the increase in PPC to consumers under the fuel cost adjustment (FCA) framework. The FCA framework approved by the Karnataka Electricity Regulatory Commission (KERC) does not allow the pass-through of variation in PPC from sources other than long-term thermal stations and is limited to variation in energy charges for these plants. The variation in PPC is approved during the annual true-up process, which happens with a lag, thus leading to cash flow mismatch. The power purchase cost of MESCOM also depends on the power allocation policy of the GoK. The actual power purchase cost was 4.5% higher than the approved power purchase cost in FY2020. The upward trend continued in FY2021 and the company's power purchase cost witnessed a significant increase owing to allocation of higher cost sources by the GoK; this phenomenon is likely to result in subdued profitability for the company during the year. The increase in power purchase costs has also resulted in a decline in the cost coverage ratio<sup>1</sup> in FY2020. A similar trend in PPC

<sup>1</sup> Ratio of the actual cash collections from customers including subsidy realised and the costs incurred by the company towards electricity distribution (including power purchase cost, other operating costs, interest, depreciation and taxes)

and a decline in electricity volume sales owing to the Covid-19 pandemic are expected to adversely impact the financial performance of the company in FY2021. Nonetheless, the company would be able to claim the revenue loss during the true-up process. The ratings are further constrained by the relatively high receivable position of MESCOM, primarily, the subsidy receivable from the GoK, given the free power policy for agriculture consumers and the inadequate subsidy payments and electricity dues from state government bodies. ICRA, however, notes that the subsidy collections have witnessed a significant improvement in FY2020 and FY2021. Subdued profitability coupled with relatively high receivable levels have led to increased short-term borrowings and high payables (to KPCL) for MESCOM. ICRA further takes note of the high level of cross-subsidisation, with higher tariffs charged to commercial and industrial consumers, which compensates for the lower rates for domestic and agriculture users. This, however, resulted in the loss of high paying industrial consumers for MESCOM over the past three years. The rating also factors in the sizeable capital expenditure plans by MESCOM, related to system improvements, that are funded through a mix of long-term debt, capital receipts and equity from the GoK.

The 'Stable' outlook on the rating of MESCOM's bank facilities reflects ICRA's opinion that the entity will maintain its strong operational efficiency and continue to be supported by the GOK, given its strategic importance as one of the state power distribution utilities. However, MESCOM's ability to improve its profitability metrics through growth in volume sales and tariff revisions in tandem with its cost structure will remain crucial from the credit perspective.

## Key rating drivers and their description

### Credit strengths

**State-owned power distribution company with cost-plus tariff** - MESCOM is a GoK-owned power distribution utility that supplies electricity to consumers in four districts of Karnataka. The utility receives regular support from the GoK in the form of equity and capital grants. The monopolistic nature of the business with cost-plus tariff principles allows the utility to pass on the variations in cost structure to consumers.

**Established regulatory processes in Karnataka** - The operations of MESCOM are supported by well-established regulatory processes in Karnataka, with presence of MYT regulations along with regular and timely issuance of tariff orders by the KERC, including annual true-up in the past years. The tariff order for FY2022 was issued in June 2021, with an average tariff hike of 3.84%.

**Healthy operating efficiency evident from lowest distribution loss among all discoms in Karnataka** - MESCOM's distribution loss level of 10.07% in FY2020 and 9.86% in FY2021 (provisional) is the lowest among all the discoms in Karnataka. This is supported by the moderately favourable customer profile, with industrial and commercial consumers accounting for 26% of the volume sales in FY2020, which is higher than for three of the other four discoms in Karnataka.

**Financial profile supports cash inflows in the form of grants, equity and consumer contribution** - The financial profile of MESCOM is supported by considerable cash inflows from consumer contributions and subsidy grants towards capital assets, security deposits from consumers and equity infusion from the GoK. The aggregate cash inflow from grants, consumer contribution and equity stood at Rs. 239 crore in FY2020.

### Credit challenges

**Increase in power purchase cost due to exposure to supply from KPCL hydel stations and GOK's power allocation policy** - The PPC for MESCOM is susceptible to availability of power supply from KPCL hydel stations. Any shortfall in availability here leads to dependence on high cost power, as seen in the past. Also, the growing sharing of renewables in the power purchase mix in recent years, has led to backing down of thermal stations (wherein discom would continue to pay the fixed charges), thereby increasing the company's PPC. This increase is further accentuated by the inability of the company to pass on the

increase in PPC to the consumers under the existing quarterly FCA framework. The FCA framework approved by the KERC does not allow the pass-through of variation in PPC from sources other than long-term thermal stations and is limited to variation in energy charges at these plants. The variation in PPC is approved during the annual true-up process, which happens with a lag. Further, the PPC depends on the allotment of power sources by the GOK each year. The power purchase cost has increased in FY2021 owing to the allocation of high-cost generation source and low procurement from the hydel power sources.

**High receivable position constraints MESCOM's financial profile** - The financial profile of MESCOM is constrained by high receivable position, comprising subsidy receipts from the GoK in lieu of the free power supply policy for agriculture consumers, electricity dues from Government bodies and regulatory asset aggregating to Rs. 2208.84 crore as on March 31, 2020. This has resulted in dependence on short-term borrowings and high payables to the state-owned power generation company, KPCL.

**Relatively high subsidy dependence due to sales to agriculture segment** - The subsidy dependence as a proportion of the operating income for MESCOM remained relatively high at around 26% of the operating income in FY2020. This is owing to the increase in share of agriculture consumers in the energy sales mix and the decline in share of industrial and commercial consumers. While the subsidy collections have improved in FY2020 and FY2021 (provisional), the overall subsidy dues from GoK remain high.

**Tariff cross-subsidisation remains high with subsidised supply to agriculture and domestic consumers** - The cross-subsidisation requirement with higher tariff rates for commercial and industrial consumers to compensate for the lower rates charged for domestic and agriculture consumers persists. This has resulted in loss of industrial consumers for MESCOM over the past few years, given the availability of cheap power in the open-access market.

**Large capital expenditure plans for MESCOM** - The company has sizeable capital expenditure plans related to investments on infrastructure improvement, feeder separation programme, consumer and feeder metering etc., which will be funded through a mix of debt, equity, consumer contribution and capital grants. While the cost associated with capital investments is considered for recovery under the cost-plus tariff principles, any delays in implementation would increase the project cost, which is exposed to risk of disallowance by the KERC. Moreover, the largely debt-funded capex puts pressure on the leverage level.

**Decline in cost coverage ratio in FY2020** – The cost coverage ratio of MESCOM witnessed a decline in FY2020 to 0.95 times, owing to increase in power purchase costs in that year. The cost coverage ratio in FY2021 is also expected to be subdued, given the increasing trend in power purchase costs for the utility and the decline in electricity volume sales amid the Covid-19 pandemic.

## Liquidity position: Adequate

The liquidity profile of the MESCOM remains **adequate** and is supported by the presence of a moderately favourable consumer profile that ensures healthy collections from consumers, monthly subsidy payments by the GoK and the availability of working capital funding limits. Moreover, the company has demonstrated ability to raise short-term debt from banks and financial institutions, whenever necessary. Further, the capex funding is met through fresh equity, capital grants, consumer contributions and long-term debt.

## Rating sensitivities

**Positive factors** - Timely issuance of tariff orders that allows pass-through of cost variations to customers, sustenance of the healthy operating efficiency and reduction in receivable position, leading to an improvement in cost coverage ratio to 0.95 times or higher on a sustained basis would be a positive trigger for the rating.

**Negative factors** - The rating could face negative pressure in case of significant delays in issuance of tariff order or inadequacy of the approved tariff, which adversely impact profitability and cash flows, Also, an increase in receivable position or higher-than-approved distribution loss levels would exert negative pressure on the rating. Further, the rating also remains sensitive to deterioration in the credit profile of the parent i.e. the Government of Karnataka.

## Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	<a href="#">Corporate Credit Rating Methodology</a> <a href="#">Rating Methodology for Power Distribution Utilities</a>
Parent/Group Support	The assigned rating factors in the systemic importance that MESCOM holds to the state power sector, which we expect should induce the GoK to extend timely financial support to the rated entity, should there be a need.
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of MESCOM

## About the company

MESCOM, incorporated in 2002, is one of the five state-owned distribution utilities in Karnataka, which are licensed to supply electricity in the five designated areas of the state. MESCOM is licensed to distribute electricity to four districts of Karnataka namely, Dakshina Kannada, Udipi, Shimoga and Chickmagalur, covering an area of 26,222 sq kms with total consumers of 2.44 million as on March 31, 2020. The other distribution utilities in Karnataka are Bangalore Electricity Supply Company Limited (BESCOM), Gulbarga Electricity Supply Company Limited (GESCOM), Hubli Electricity Supply Company Limited (HESCOM) and Chamundeshwari Electricity Supply Corporation Limited (CESCOM). The transmission function in Karnataka is under state owned Karnataka Power Transmission Corporation Limited (KPTCL), while the state-owned power generation assets are under KPCL.

## Key financial indicators

MESCOM Standalone	FY2019 (Audited)	FY2020 (Audited)
Operating Income (Rs. crore)	4,021.6	3,876.3
PAT (Rs. crore)	940.1	71.8
OPBDIT/OI (%)	30.4%	9.7%
PAT/OI (%)	23.4%	1.9%
Total Outside Liabilities/Tangible Net Worth (times)	3.9	3.0
Total Debt/OPBDIT (times)	1.0	3.4
Interest Coverage (times)	9.2	2.5

PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation

## Status of non-cooperation with previous CRA: Not applicable

## Any other information: None

## Rating history for past three years

	Instrument	Current Rating (FY2022)			Chronology of Rating History for the past 3 years				
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of Jul 31, 2021 (Rs. crore)	Date & Rating	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019
					Sep 28, 2021	Jun 29, 2021	Apr 17, 2020	-	Mar 12, 2019
1	Term loans	Long Term	1631.87	1223.06	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)
2	Fund-based	Long Term	500.00	-	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)
3	Non-fund based	Short Term	200.00	-	[ICRA]A2	[ICRA]A2	[ICRA]A2	-	[ICRA]A2
4	Unallocated		18.13	-	[ICRA]BBB+ (Stable) / [ICRA]A2	-	-	-	[ICRA]BBB+ (Stable) / [ICRA]A2

## Complexity level of the rated instruments

Instrument	Complexity Indicator
Fund-based – Term Loan	Simple
Fund-based – Overdraft	Simple
Non-fund based - Letter of Credit	Very Simple
Unallocated	NA

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analyzing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments, is available on ICRA's website: [www.icra.in](http://www.icra.in)

**Annexure-1: Instrument details**

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (RS Crore)	Current Rating and Outlook
NA	Term Loan	Feb 2009	-	May 2031	1631.87	[ICRA]BBB+ (Stable)
NA	Fund-based Limit	-	-	-	500.00	[ICRA]BBB+ (Stable)
NA	Non-fund-based Limit	-	-	-	200.00	[ICRA]A2
NA	Unallocated	-	-	-	18.13	[ICRA]BBB+ (Stable) / [ICRA]A2

Source: Company

**Annexure-2: List of entities considered for consolidated analysis: Not Applicable**

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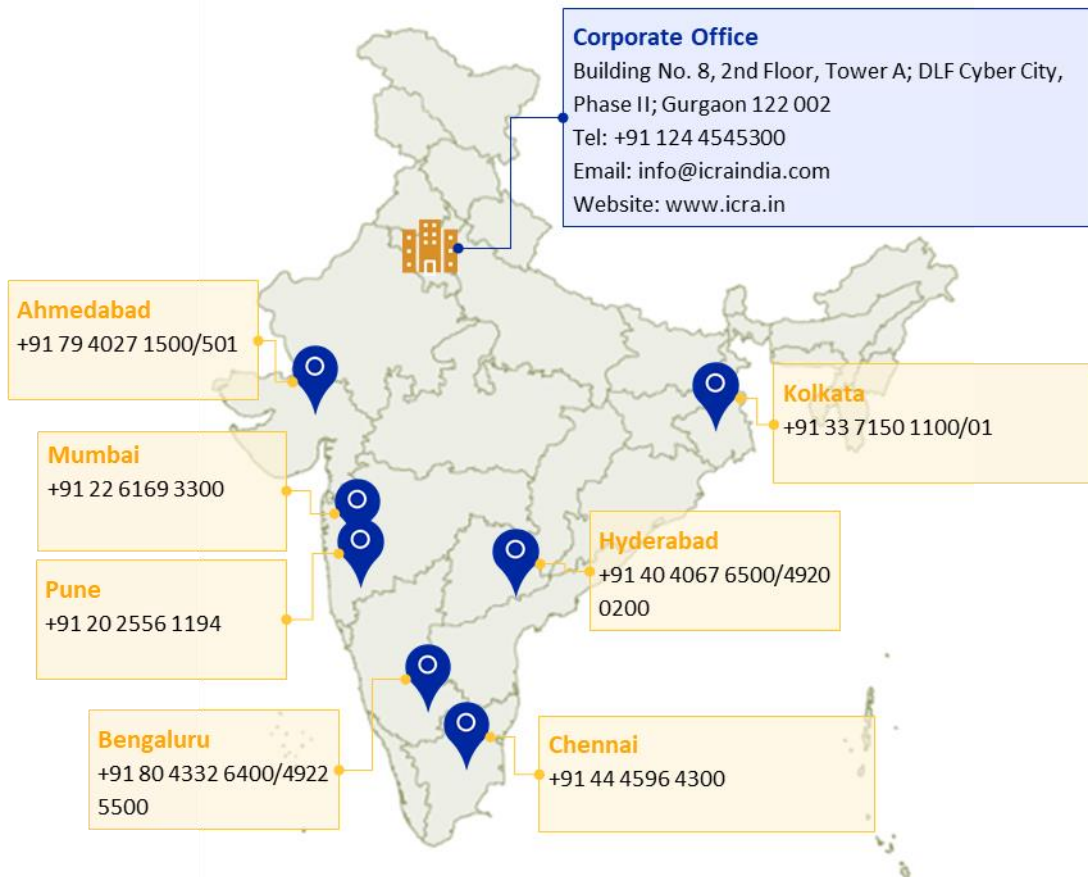
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