April 17, 2020

Mangalore Electricity Supply Company Limited: Rating reaffirmed; rated amount enhanced

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund based - Term loan	754.86	1275.00	[ICRA]BBB+ (Stable); reaffirmed and amount enhanced
Fund based - Overdraft	400.00	400.00	[ICRA]BBB+ (Stable); reaffirmed
Non-Fund based limit	175.00	175.00	[ICRA]A2; reaffirmed
Unallocated	20.14	Nil	-
Total	**1350.00**	**1850.00**	

**Instrument details are provided in Annexure-I*

Rationale

ICRA's rating reaffirmation factors in the 100% ownership of Mangalore Electricity Supply Company Limited (MESCOM) by the Government of Karnataka (GoK), the strategic importance of the company to the state power sector and the monopolistic nature of business supported by cost-plus tariff-based principles. The ratings continue to draw strength from the healthy operating efficiency of MESCOM, as reflected by the relatively low distribution loss level of 10.5% in FY2019. The ratings are also supported by the established regulatory process in the state, evident from the presence of the multi-year tariff (MYT) regime, regular issuance of tariff orders with upward tariff revision and annual true-up of the actual performance of the distribution companies (discoms). 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. ICRA takes note of the significant decline in power purchase cost (PPC) per unit for MESCOM to Rs. 3.72 per unit in FY2019 from Rs. 4.43 per unit in FY2018, supported by higher power supply from low-cost hydel stations. As a result, the gap between the approved PPC and the actual PPC declined to 35 paise per unit in FY2019 from 82 paise per unit in FY2018. This has allowed the company to improve its cash flows and its cost coverage ratio[1] in FY2019. The sustainability of the healthy cost coverage ratio remains dependent on timely realisation of subsidy payments from the GoK, the extent of gap between the actual and the approved PPC, and the approval of cost reflective tariffs by the Karnataka Electricity Regulatory Commission (KERC).

The rating, however, is constrained by the vulnerability of MESCOM's PPC to availability of power supply from the hydel stations of Karnataka Power Corporation Limited (KPCL); any shortfall here would lead to dependence on high cost power as seen in the past. Also, the growing sharing of renewables in the power purchase mix of MESCOM in recent years has led to backing down of long-term thermal stations, wherein discom would continue to pay the fixed charges. This could lead to increase in PPC for the company. This is further accentuated by the inability of the company to pass on the increase in PPC to consumers under the fuel cost adjustment (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 for these plants. The variation in PPC is approved during the annual true-up

[1] 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)

process, which happens with a lag, thus leading to cash flow mismatch. The rating is further constrained by the high receivable position of MESCOM, primarily 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. The subsidy dependence as a proportion of the operating income increased to 26-28% during FY2017-FY2019 from 20-21% during FY2014-FY2016. This is owing to the increase in share of agriculture consumers in the energy sales mix of MESCOM. This has led to dependence on short-term borrowings and high payables for MESCOM. ICRA further takes note of the high level of cross-subsidisation with higher tariffs charged to commercial and industrial consumers, compensating 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.

Further, the lockdown imposed in India to control the COVID-19 pandemic is expected to have an adverse impact on the cash flows of power distribution entities, because of decline in electricity demand as well as constraints in collections from consumers, which would in turn affect the cash flows for MESCOM. Also, the tariff order for FY2021 may get delayed because of the ongoing lockdown. The extent of lockdown and its consequent impact on the cash flows of MESCOM remains a key rating monitorable.

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 FY2020 was issued in May 2019 with an average tariff hike of 4.8%.

Healthy operating efficiency reflected from lowest distribution loss among all discoms in Karnataka - MESCOM's distribution loss level of 10.5% in FY2019 is lowest among all the discoms in Karnataka. This is supported by moderately favourable customer profile, with industrial and commercial consumers accounting for 31% of the volume sales in FY2019, which is higher than for three of the other four discoms in Karnataka.

Healthy cost coverage ratio - Despite the higher-than-approved PPC, the cost coverage ratio for MESCOM remained above 100% in FY2018 and FY2019, supported by increase in the tariff realisation, decline in power purchase cost led by higher supply from low cost hydel stations and recovery of past receivables from village panchayat's under the scheme approved by the GoK in FY2018. However, the cost coverage ratio is likely to be adversely impacted in the near term, because of the decline in electricity demand and collections amid COVID-19 lockdown.

Financial profile supported 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 GoK. The aggregate cash inflow from grants, consumer contribution and equity stood at Rs. 307.0 crore in FY2019.

Credit challenges

PPC for MESCOM remains exposed to availability of supply from KPCL hydel stations - 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). This could lead to increase in PPC for the company. This 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 for these plants. The variation in PPC is approved during the annual true-up process, which happens with a lag.

Financial profile of MESCOM is constrained by high receivable position - 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. 1958.14 crore as on March 31, 2019. This has resulted in dependence on short-term borrowings and high payables to KPCL.

High subsidy dependence - The subsidy dependence as a proportion of the operating income for MESCOM increased to 26-28% during FY2017-FY2019 from 20-21% during FY2014-FY2016. 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. This coupled with inadequate subsidy payments from GoK has led to large subsidy dues from GoK.

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 cheaper power in the open-access market.

Large capital expenditure plans for MESCOM - The company has sizeable capital expenditure plans, with the KERC approved capex of Rs. 1958 crore over FY2020-22, 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 the 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. Also, the largely debt-funded capex puts pressure on the leverage level.

Liquidity position: Adequate

The liquidity profile of the utility is supported by the presence of a moderately favourable consumer profile, leading to healthy collection efficiency. However, this is constrained by delays in receipt of subsidy support from the GoK and payments by Government institutions. Nonetheless, the presence of working capital facilities from multiple banks and the ability to raise short-term debt from financial institutions are mitigants. The company has undrawn working capital lines of Rs. 123 crore as of March 2020. Also, the security deposits from consumers provide some liquidity buffer. The capex funding is met through fresh equity, capital grants, consumer contributions and long-term debt.

Rating sensitivities

Positive triggers – Timely issuance of tariff orders allowing pass-through of cost variations to customers, sustenance of the healthy operating efficiency, and a reduction in receivable position, leading to the cost coverage ratio remaining at 1.00 times or higher would be positive trigger for the rating.

Negative triggers – The rating could face negative pressure in case of significant delays in issuance of tariff order or inadequate tariff approval, adversely impacting profitability and cash flows, Also, the increase in receivable position and/or higher-than-approved distribution loss levels would exert negative pressure on the rating.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Power Distribution Utilities
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	The rating is based on the standalone financial profile of the company.

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 in four districts of Karnataka namely, Dakshina Kannada, Udipi, Shimoga and Chickmagalur, covering an area of 26,222 sq kms with total consumers of 2.43 million as on December 31, 2019. 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 (audited)

	FY2018	FY2019
Operating Income (Rs. crore)	3632.50	4021.63
PAT (Rs. crore)*	31.42	56.39
OPBDIT/OI (%)	17.54%	30.37%
RoCE (%)	34.23%	61.25%
Total Debt/TNW^ (times)	1.33	1.04
Total Debt/OPBDIT (times)	1.71	1.01
Interest Coverage (times)	5.46	9.21

*PAT after prior period changes (adjusted for regulatory asset movement)
^Tangible net-worth includes capital grants

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Instrument	Current Rating (FY2021) Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	April 17, 2020	Chronology of Rating History for the past 3 years: Date & Rating in FY2020 -	Date & Rating in FY2019 March 12, 2019	Date & Rating in FY2018 March 30, 2018
1	Term loans	Long term	1275.00	1275.00	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)
2	Fund-based	Long term	400.00	-	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)
3	Term loans	Short term	-	-	-	-	-	[ICRA]A2
4	Non-Fund based limit	Short term	175.00	-	[ICRA]A2	-	[ICRA]A2	[ICRA]A2
5	Unallocated	Long term/ Short term	Nil	-	-	-	[ICRA]BBB+ (Stable) / [ICRA]A2	[ICRA]BBB+ (Stable) / [ICRA]A2

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument Details

ISIN No	Instrument Name	Date of Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term loans	February-2009	NA	October 2027	1275.00	[ICRA]BBB+ (Stable)
NA	Fund-based limit	-	-	-	400.00	[ICRA]BBB+ (Stable)
NA	Non-fund-based limit	-	-	-	175.00	[ICRA]A2

Source: MESCOM

Annexure-2: List of entities considered for consolidated analysis

Not applicable

ANALYST CONTACTS

Sabyasachi Majumdar
+91 124 4545304
sabyasachi@icraindia.com

Girishkumar Kadam
+91 22 6114 3441
girishkumar@icraindia.com

Vikram V
+91 40 40676518
vikram.v@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai + (91 22) 24331046/53/62/74/86/87
Chennai + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore + (91 80) 2559 7401/4049
Ahmedabad+ (91 79) 2658 4924/5049/2008
Hyderabad + (91 40) 2373 5061/7251
Pune + (91 20) 2556 0194/ 6606 9999