CARE Research

DISCOM bailout-questionable State finances, bank NPV hit in offing..

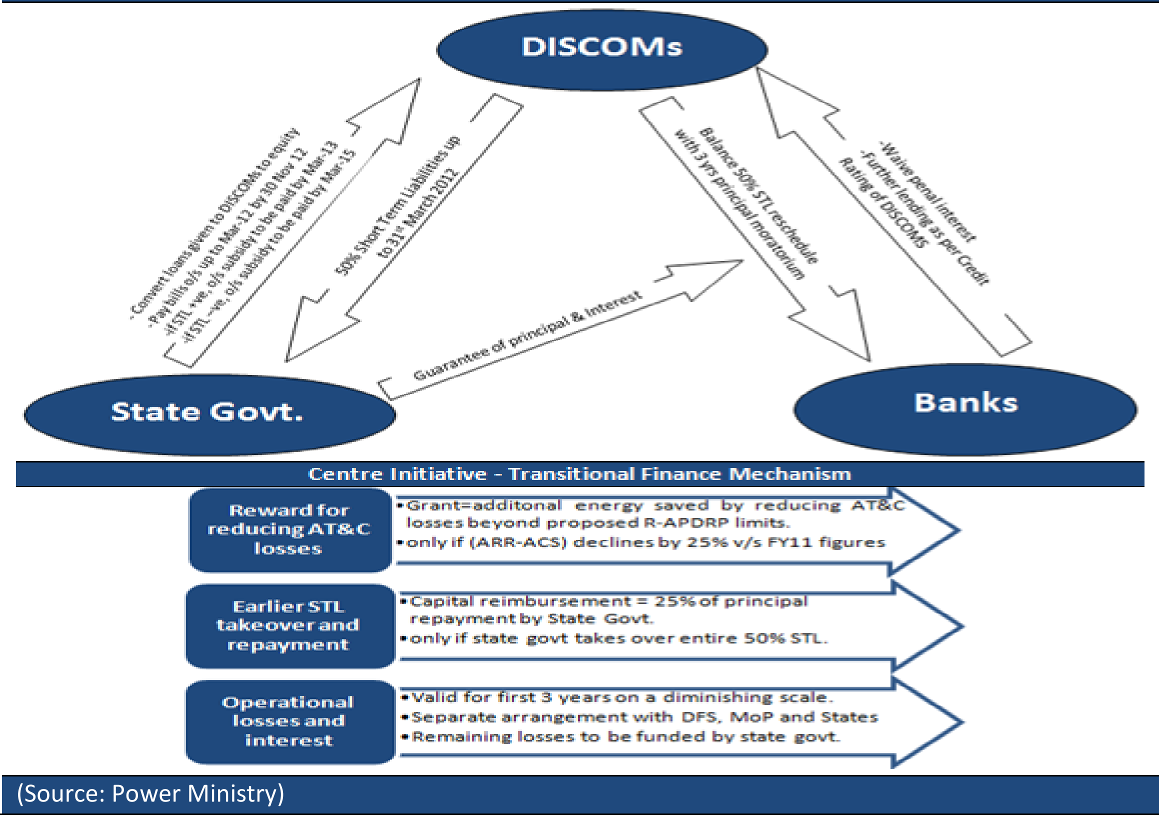
Financial Restructuring Plan (FRP)-more of SEB bailout package, not much for banks

The current carrot-and-stick scheme announced by the Central government to State power distribution companies is an attempt to restore power purchasing capacity of the debt-ridden DISCOMs and enable banks to recover their loans. **CARE Research** thinks that though this scheme is better than the earlier bailout package offered in 2002 (where no stringent conditions were put in), it puts onus on the respective states and DISCOMs and mandates them to initiate proactive measures like 1) regular tariff revision 2) curb AT&C losses sustainably (around 15% v/s 27% at present) to improve viability and 3) revenue-cost gap reduction over the moratorium period.

Moreover, the States involved in the current FRP may also find it difficult to adhere to their respective fiscal deficit limits (enacted under FRBM Act), given 1) acceptance of weaker states for the central restructuring package 2) doubts over the tariff hike momentum continuing given the approaching elections in the next 12-18 months 3) ability of states to service the increased liabilities given the dismal condition of most state finances and 4) limited room for states given bulging subsidies and anticipated slower revenue growth.

CARE Research is also cautious on banks with a higher exposure to DISCOMs especially in the seven states (approximately 90% of total banks' DISCOMS exposure) as 1) banks may have to take upfront NPV hit on DISCOM bonds and 2) MTM losses over the bond tenure.

Table 1: Salient features of the Restructuring Scheme and Transitional Finance Mechanism



(Source: Power Ministry)

CARE Ratings
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Restructuring to benefit in short term; functional autonomy key for long term

The Cabinet-approved FRP involves the states to take-over half of the Short Term Liabilities (STL) through issuance of special securities (non-SLR bonds) in favour of participating lenders in a phased manner, according to the fiscal limits available (under FRBM Act). However, the balance 50% STL need to be restructured by the banks with a 3-year moratorium period and duly guaranteed by state governments. **CARE Research** believes that though the FRP can bring short-term relief for cash-strapped DISCOMs, its long-term success will hinge on the ability of DISCOMs to raise tariffs/cut AT&C losses and regular subsidy payments by states.

Underpaid subsidies; underestimated losses - key concerns for State DISCOMs

The Shunglu Committee Report, which evaluated 15 state distribution companies (approximately 91% of electricity consumed), has referred to a significant rise in 'Other Current Assets' in the books of DISCOMs over FY09-FY11. The components of 'Other Current Assets' are highly "opaque" with likely possibility of subsidy booked, but not received with higher proportion of agricultural losses (than accounted for) being hidden. It also cites the receivable days in states of Bihar, MP and UP taking an astonishing 240-600 days, raising doubts over quality of debtors and increased working capital cycle.

Table 2: Losses are hidden in "Other current Assets"

BS items of 15 State DISCOMs			(Rs bn)
SOURCES	Mar-05	Mar-10	Change(%)
Own funds	250	580	132%
Loan funds :			
State governments	150	240	60%
Others	560	1610	188%
Current liabilities	520	1530	194%
Total	**1480**	**3960**	168%
UTILIZATION			
Accumulated Losses	190	1070	463%
Fixed Assets	670	1280	91%
Investments	10	60	500%
Stocks	30	70	133%
Debtors	310	560	81%
Other current assets/advances	270	920	241%
Total	1480	3960	168%

There is no clarity over "Other current Assets" with certain DISCOMS such as UP, Rajasthan and AP.

Source: Shunglu Committee Report and CARE Research

Regulatory assets pile up- regulators avoid tariff shocks even for validated costs

The regulators have often dissallowed even validated costs, leading to creation of regulatory assets to avoid tariff shocks to end-consumers. **CARE Research** notes that regulatory assets are significantly higher in case of UP, TN and Rajasthan (e.g. as high as Rs.79 bn for TN). Few of the state regulators have not revised tariffs on account of non-filing of Annual Revenue Requirement (ARR) by DISCOMs.

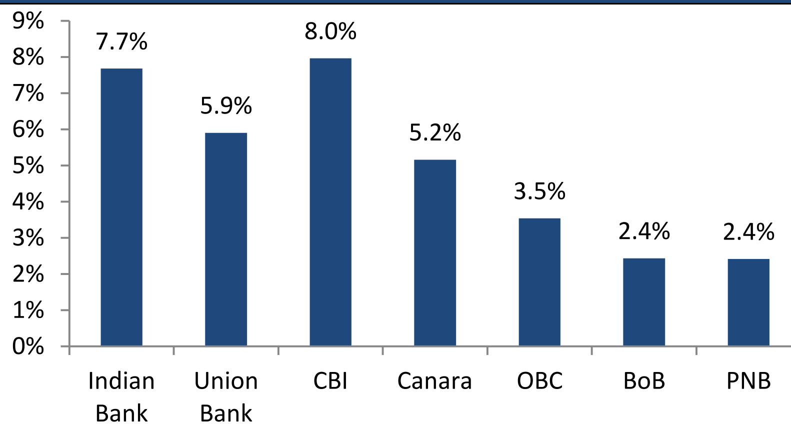
Thus, going forward, it is vital for state DISCOMs to file tariff hikes, substaintially higher not only to cover incremental fuel and other recurring costs but also to amortize regulatory asstets (related accumulated historical costs) on a regular basis.

Banks: Cautious in short term; asset quality to improve in long term

Most of the banks have already initiated restructuring of DISCOMs advances on their own and **CARE Research** estimates from the industry sources that banks have already restructured around 45% of the total DISCOM advances in the past few quarters. The DISCOM restructuring package has reduced the asset quality concerns and offered banks with additional comfort in the form of state guarantee on the DISCOM advances.

Given the lack of clarity on the interest rate at which the bonds will be issued by the SEBs, risk premium and term premium, it is difficult to calculate the loss in Net Present Value terms in the books of the banks. CARE Research expects that in the short term (up to two years) the scheme would entail a risk of NPV hit, if bond coupon is lower coupled with the rollover of MTM losses thus impacting the banks' earnings. In our view, the below-stated scenario analysis (Table VI), implies that banks are expected to take around Rs.60 bn NPV hit, with an assumption of 8% NPV hit on 50% of STL (issued as bonds) and 2% NPV hit on balance 50% of STL (restructured with 3-year moratorium period). However, banks are likley to draw comfort on capital adequacy post proposed restructuring plan, since the risk weight attached on bonds would be lower as they will carry a guarantee by state governments.

Table 3.1: Exposure of banks as % of loan book



Source: Media reports, company web, press release

Table3.2: Total expected NPV loss to be borne by banking industry (Rs. Cr)

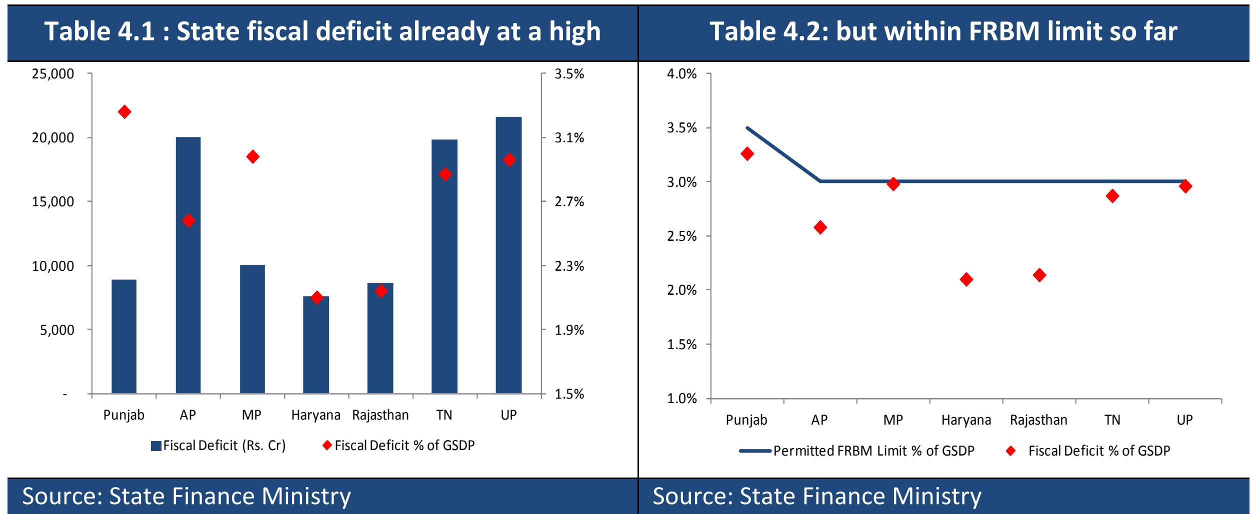
NPV loss on 50% loan Restructured	NPV loss on 50% loan coverted to bonds					
	5.0%	**6.0%**	**7.0%**	**8.0%**	**9.0%**	**10.0%**
0.5%	3290	3888	4486	5084	5682	6280
1.0%	3589	4187	4785	5383	5981	6579
1.5%	3888	4486	5084	5682	6280	6878
2.0%	4187	4785	5383	5981	6579	7178
2.5%	4486	5084	5682	6280	6878	7477
3.0%	4785	5383	5981	6579	7178	7776

Source: Ministry of Power (Mop) & CARE Research

State Govt. Finances- growth scenario bleak; limited room left

The prevailing financial condition of state government finances is not very encouraging. The fiscal deficit of all the seven states being presently studied is already > 2% of their respective GSDP due to slowing economy and unabated expenditure. As per the FRBM Act, state governments are mandated to maintain the fiscal deficit of around 3% of their GSDP (3.5% in case of Punjab). However, the fiscal deficit of the mentioned seven states is already between 2.1% to 2.98% (3.26% in case of Punjab) as per their FY13 budgets. Thus, they have very limited fiscal room to absorb any more liabilities on their books.

Table 4.1 : State fiscal deficit already at a high | **Table 4.2: but within FRBM limit so far**



Source: State Finance Ministry | Source: State Finance Ministry

The restructuring scheme directs state government to take over the short-term liability of DISCOMs through issuance of special securities in favour of participating lenders in a phased manner up to amounts possible as per the state FRBM limit. **CARE Research** estimates that the states would find it challenging to meet the schedule set as per the draft issue by MoP.

Table 5: Phasing of special securities to be issued by the State Govt to Discoms (Rs. Cr)

Sr No	State	50% of STL	Pre-General Election		Post-General Election		
			2012-13	2013-14	2014-15	2015-16	2016-17
1	Punjab	5,823	881	1,004	1,145	1,305	1,488
2	AP	3,151	2,211	940	-	-	-
3	MP	585	72	513	-	-	-
4	Haryana	7,859	2,518	2,496	2,845	-	-
5	Rajasthan	19,855	2,649	3,496	3,986	4,544	5,180
6	TN	9,573	884	2,526	2,880	3,283	-
7	UP	12,967	1,919	2,245	2,559	2,918	3,326
	Total	**59,813**	**11,134**	**13,220**	**13,415**	**12,050**	**9,994**

Source: MoP

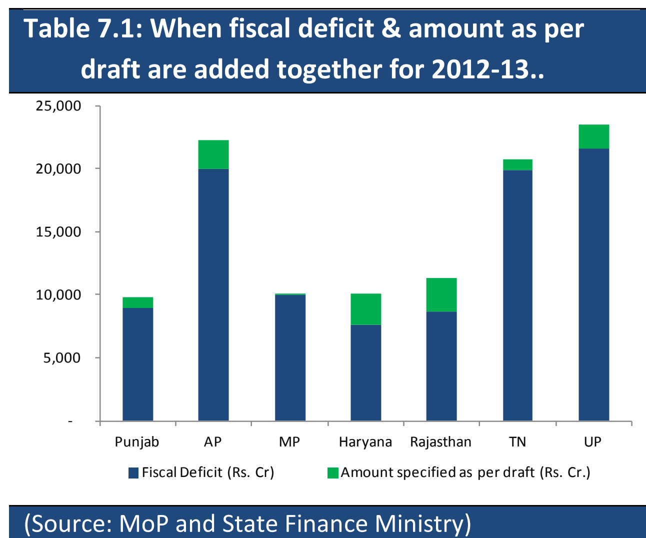
CARE Research analysis suggests that if the state governments follow the draft schedule, only 4 (highlighted with green below) out of 7 states would meet the required amount as per space available in FRBM limit in 2012-13. However, the remaining 3 states (highlighted with red below) fiscal deficit percentages may cross the limit set by their respective FRBM Act (Table 7).

Table 6: Analysis of availability of Space in state FRBM limit to absorb the loan amount

State	Fiscal Deficit (Rs. Cr)	50% STL (Rs. Cr)	GSDP (Rs. Cr.)	Fiscal Deficit as % of GSDP	Permitted FRBM Limit % of GSDP	Space available between State Fiscal deficit and FRBM limit	Space available in State FRBM limit (Rs.Cr.)	Amount specified as per draft (Rs. Cr.)
Punjab	8,924	5,823	273,740	3.26%	3.5%	0.24%	657	881
AP	20,008	3,151	775,504	2.58%	3.0%	0.42%	3,257	2,211
MP	10,018	585	336,174	2.98%	3.0%	0.02%	67	72
Haryana	7,597	7,859	361,762	2.10%	3.0%	0.90%	3,256	2,518
Rajasthan	8,651	19,855	404,252	2.14%	3.0%	0.86%	3,477	2,649
TN	19,832	9,573	691,015	2.87%	3.0%	0.13%	898	884
UP	21,570	12,967	728,716	2.96%	3.0%	0.04%	291	1,919

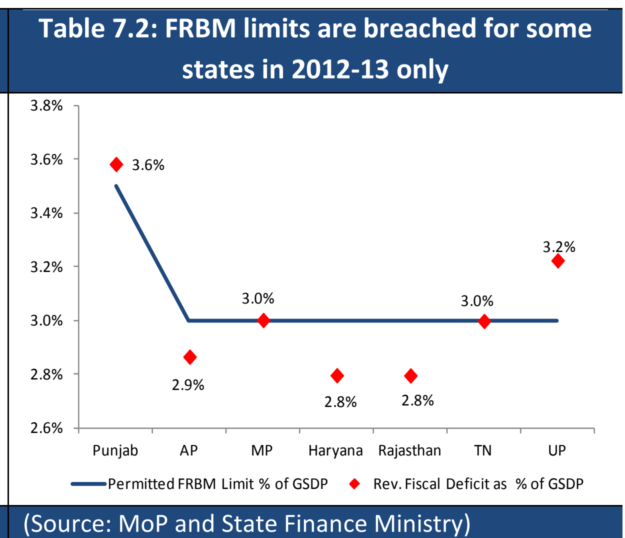
(Source: MoP, State Finance Ministry and CARE Research)

Table 7.1: When fiscal deficit & amount as per draft are added together for 2012-13..



(Source: MoP and State Finance Ministry)

Table 7.2: FRBM limits are breached for some states in 2012-13 only



(Source: MoP and State Finance Ministry)

Additionally, the states had formulated their budgets during strong economic situation and better market sentiments. With an expected decline in GDP growth impacting the revenues of states and centre, the situation may be more complex. For instance, CARE Research estimates that on an average, with a 100 bps decline in GSDP of Tamil Nadu, the fiscal deficit will increase by around 20 bps. This implies meeting the budgeted fiscal deficit even without the special securities would be an uphill task for the states, which many may not be able to accomplish. The state governments would have to go in for additional new taxes/sale of assets to raise resources. However, with state election due in Rajasthan and MP in December 2013 and a general election due in 18 months, such revenue-raising measures seem difficult. So, it might involve shifting of special security issuance to post-election period i.e. 2014-17.

Table 8: Tamil Nadu – Gap in est. & actual GDP growth and fiscal deficit; and their ratio

Year	Est. GDP Growth	Act. GDP Growth	Est. Fiscal Deficit	Act. Fiscal Deficit	Gap in Act. & est. GDP	Gap in Act. & est. Deficit	Ratio of Gap
2008-09	6.09%	4.55%	2.98%	3.18%	-1.54%	0.20%	-0.13
2009-10	10.00%	8.96%	2.96%	3.23%	-1.04%	0.27%	-0.26
2010-11	11.74%	10.00%	2.73%	3.21%	-1.74%	0.48%	-0.28
2011-12	9.40%	8.70%	2.85%	2.96%	-0.70%	0.11%	-0.16
2012-13e	**9.20%**	**8.20%**	**2.87%**	**3.07%**	**-1.00%**	**0.20%**	**-0.20**

Source: State Finance Ministry and CARE Research estimates

To conclude, the current restructuring plan will make DISCOMs self-sustainble only if the states proactively create fiscal space and enable improvement in DISCOM operational parameters by 1) allowing legitimate tariff hikes on consistent basis 2) initiating reduction in AT&C losses by ensuring implementation of Distrbution Franchisee and R-APDRP scheme 3) autonomus functioning of DISCOMs and 4) strict monitoring of the proposed turnaround plan.

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