Lower Erkhuwa Hydropower Company Limited: [ICRANP] LB+/A4 assigned

May 25, 2020

Summary of rated instruments

Instrument *	Rated Amount (NPR Million)	Rating Action
Long-term loan; Fund based	1,689.2	[ICRANP] LB+; Assigned
Short-term loans; Fund based	35	[ICRANP] A4; Assigned
Short-term loans; Non-fund based	8.2	[ICRANP] A4; Assigned
Total	**1,732.4**	

** Instrument details are provided in Annexure-1*

Rating action

ICRA Nepal has assigned a long-term rating of [ICRANP] LB+ (pronounced ICRA NP L B Plus) to Lower Erkhuwa Hydropower Company Limited's (LEHCL) long-term loan and a short-term rating of [ICRANP] A4 (pronounced ICRA NP A four) to its short-term loans.

Rationale

The assigned ratings are constrained by the inherent project execution risks associated with the 13.04-MW Lower Erkhuwa Khola HPP with the project being in its initial stages of development (~10% progress as of mid-April 2020). The risk, further, remains accentuated by the possible geological surprises that can surface during the excavation of the 2,636-m long tunnel structure which is around 20% complete so far. Likewise, the fact that the major work contracts across other civil, hydromechanical, electromechanical and transmission line works are yet to be signed further pressurises the timely project execution amid the ongoing Covid-19 pandemic lockdown that has resulted in limited resource mobilisation and slackness in work. In such a scenario, the company may not be able to meet its current required commercial operation date (RCOD) of July 17, 2022, which exposes the project to possible project cost escalation, late COD penalty and loss of tariff escalations. However, the extent of such an exposure would remain dependent on the possible extension of the RCOD by the Nepal Electricity Authority (NEA) owing to the effect of the Covid-19 lockdown on the hydropower sector in general as well as the recent change[1] in the delivery point of the project in specific. Further, the ratings also remain constrained by the high funding risk with only ~25% of the equity component infused so far and yet to be concluded consortium loan agreement[2] for financing the project. This risk, further, remains accentuated by weak financials of the parent company, the National Hydro Power Company Limited (NHPC), as well as the distant possibility of concluding the consortium agreement amid the ongoing Covid-19 pandemic lockdown, thus necessitating the immediate further equity infusion from the promoters amid the ongoing construction progress. Likewise, the assigned ratings also remain constrained by the monthly short supply penalty as well as the 30% dry energy short supply penalty as indicated in the PPA, which can impact the revenue profile of the company in case of fluctuations in hydrology. Similarly, ratings concern also arises from hydrological risks, given the absence of a deemed generation clause in the power purchase agreement (PPA) for which no compensation is payable to the company by the NEA in case of an adverse flow in the river. The ratings are also constrained by the counterparty credit exposure of the NEA, which has a moderate financial profile (with recent improvements). This is partly mitigated by the sovereign support of the Government of Nepal (GoN) to the NEA and its past track record of timely payments to independent power producers (IPPs).

Nonetheless, the assigned ratings consider the presence of an experienced board of directors and key managerial personnel who have previous experience in operational as well as under-constructional hydropower projects. The ratings also remain supported by the presence of a high dry energy mix of ~30% under the new six months dry:wet energy mix in PPA and eight tariff escalations on the base tariff rate, which would be supporting the revenue profile, return indicators and other coverage

[1] *The delivery point of the project has been changed from the erstwhile 220kV Khadbari substation to 220/132kV Sitalpati substation which the NEA targets to complete by December 2022, triggering the extension of current RCOD in line with the NEA's targeted completion date viz. December 2022*

[2] *Only a term sheet has been tied-up with Machhapuchchhre Bank Limited which has agreed to lead the consortium, however, it is yet to finalise the participating banks to form the same.*

ratios amid the fixed tariff regime. Further, the ratings also take comfort from the firm long-term PPA for the entire project capacity, which eliminates the tariff risk and offtake risk for the energy to be generated by the project.

Going forward, LEHCL's ability to swiftly execute the remaining works contract and expedite the works soon after the lift-up of the lockdown, timely infuse the balance equity from the major promoter, and its ability to tie up the entire loan component - would determine the project's completion schedule as well as the associated costs of project development. Likewise, the extension of the RCOD by the NEA to address slackness in work, due to the lockdown, in the hydropower sector in general, and address change in delivery point in specific determining the tariff escalations are important. Also, availability of the NEA's evacuation structures before the project becomes operational, achieving its designed operating parameters and interest rate volatility in the market are considered the key drivers for determining the project return metrics and coverage indicators for the company

Key rating drivers

Credit strengths

Prior experiences of the board of directors and management team in the hydropower sector remain a comfort – The board of directors and the management of the company comprise an experienced team with representation from the technical/engineering sectors who have prior experience in the hydropower sector. Mr. Kumar Pandey, chairman of the company, also an executive chairman of NHPC that operates a 7.5-MW Indrawati III HPP, is the chairperson of the board of directors and is a renowned name in the hydropower sector. The past experiences of the team in the sector are expected to aid the constructional aspect as well the operational aspect of the project.

Return indicators remain supported by high dry energy mix as well as the presence of eight tariff escalations – The energy tariffs have been contracted under the six-months dry energy and six-months wet energy modality with a share of ~30% dry energy in the overall mix. This, coupled with eight times tariff escalation on the base tariff (NPR 4.8/unit for wet energy and NPR 8.4/unit for dry energy) in PPA would further support the revenue profile, return indicators and coverage indicators of the company amid the fixed tariff regime. Based on our projections, the levelised tariff is around NPR 6.73/unit while the cumulative DSCR is around 1.39x.

Low tariff risk, given long-term PPA at predetermined tariffs and escalations – The tariff risk for the project is low as the company has a 30-year PPA for the project with the NEA (the sole purchaser and distributor of electricity in Nepal) for its entire project capacity of 13.04MW. The dry energy mix for the project is ~31% with a pre-defined tariff of NPR 4.8 per kWh for the wet season and NPR 8.4 (December- May) per kWh for the dry season with 3% annual escalation for eight times.

Low offtake risk, however, provision of 10% reserve margin clause in the PPA – The offtake risk for the project is low, given the presence of the take-or-pay PPA for the entire energy from the 13.04-MW capacity. However, a provision of 10% reserve margin clause in the PPA for the specified period empowers the NEA to offtake such 10% energy based on the dispatch instruction of the load dispatch centre, without paying any compensation to LEHCL. The revenue of the company is likely to be impacted if such a scenario prevails.

Credit challenges

Inherent project execution risk given initial stage of project development and incomplete major works contract – The 13.04-MW project is in its initial stage of development (10% progress so far) with substantial tunnel works yet to be achieved. The tunnel excavation works is ~20% complete so far (~500m excavated out of the total tunnel of 2,636m), which exposes the project to inherent project execution risks. This, further, remains accentuated by the possible geological surprises in the rock quality that may emerge during a further tunnel excavation, which can impede the pace of construction. Similarly, the company is yet to award its major construction works contract of civil, hydro-mechanical, electro-mechanical and transmission line works, which further exposes it to project execution risk. The company's ability to enter the other works contract as soon as possible, expedite the works thereafter and commence the project operation within the budgeted cost and targeted COD is critical going forward.

High funding risk given 25% equity infusion and yet-to-be tied-up debt component – The project has been planned to be developed at a budgeted cost of NPR 2,413 million at a D:E ratio of 70:30. On the equity front, only ~NPR 177 million (~25%) of the overall required equity component of ~NPR 724 million has been injected till mid-April 2020. Similarly, a debt

component of NPR 1,690 million is yet to be tied up as only a term sheet has been tied up with Machhapuchchhre Bank Limited **(Rated [ICRANP-IR] A- by ICRA Nepal)** which has agreed to lead the consortium once the same is finalised with other participating banks. The funding risk further remains accentuated with the weak financial health of the major promoter that resulted from past corporate governance issues as well as the distant possibility of entering the consortium amid the ongoing Covid-19 pandemic, which might necessitate immediate equity infusion from the promoters, thus pressurising the timely funding arrangements. Thus, the company's ability to crystallise the debt funding by entering the consortium agreement as soon as possible and arrange the balance promoters' equity on time would determine the funding risk going forward.

High evacuation risk given nascent stage of NEA's evacuation structures – The energy to be generated from the project has been planned to be evacuated through the NEA's proposed under-construction substation at Sitalpati, which was changed from its earlier proposed Tumlingtar (erstwhile Khadbari) substation. The completion of the proposed NEA's Sitalpati substation before the project becomes operational remains critical for evacuation of the project's energy. Any delays in the completion of the structures, before the project comes into operation (RCOD of July 2022), would have a bearing on the company's revenue profile. The past trend of a delay seen in the timely construction of evacuation structures by the NEA remains a concern, particularly amid the ongoing Covid-19 pandemic which has slowed the progress of the same.

Penalty clauses in case the project is unable to deliver 30% dry energy and supply required monthly energy – The company shall be liable for penalties in case the project is unable to deliver the required 30% dry energy as well as the declared monthly energy to the NEA. As per the PPA, if the project is unable to supply a minimum of 30% of the overall energy supplied, then the energy supplied in the dry season shall be considered as 30% of the total energy and hence, total energy shall be calculated and the company shall not be paid for the energy supplied above such calculated total energy. Besides, a minimum dry energy supply, the company is also expected to deliver the minimum monthly energy, failure of which would also attract a penalty. Seasonal fluctuations in hydrology of the river in the dry months as well as in the wet months would play a role in determining such penalties.

High hydrology risk, given lack of deemed generation clause in PPA – The lack of a deemed generation clause in the PPA exposes the project to hydrology risk in case of adverse river flow scenarios without receiving any compensation for such losses.

Analytical approach: For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below.

Links to applicable criteria:
Corporate Credit Rating Methodology

About the company

Lower Erkhuwa Hydropower Company Limited (LEHCL), incorporated on Feb 10, 2008 as a public limited company, has a paid-up capital (including advances for share capital) of ~NPR 177 million as of mid-April 2020, which is 100% promoter held. As of mid-April 2020, the major promoters include M/s National Hydro Power Company Limited (67%), Mr. Shyam Bahadur Basnet (3%), Mr. Shibaram Pradhan (3%), Mr. Bishweshwor Subedi (2%) and Mr. Kumar Pandey (2%) - the rest being aggregately held by 47 individual shareholders.

The company is developing a 13.04-MW Lower Erkhuwa Khola Hydropower Project in Bhojpur district, Province No. 1 of Nepal. The project is a run of the river (R-o-R) type, being developed at 40% probability of exceedance (Q40). The PPA for the project has been entered under the six-month dry energy and six-month wet energy modality with a dry energy mix of ~30%. The budgeted cost of the project is ~NPR 2,413 million, which has been planned to be funded in a D:E ratio of 70:30. As of mid-April 2020, the promoters have infused ~25% of the overall equity requirement (~NPR 724 million) and has also entered a term sheet for the loan arrangement of ~NPR 1,689 million with Machhapuchchhre Bank Limited (lead bank) on October 24, 2019, which is yet to finalise the participating banks. The project is in the initial stages of development with a financial progress of around 10% as of mid-April 2020.

Annexure-1: Instrument details

Instrument *	Rated Amount (NPR Million)	Rating Action
Fund based facilities; Long term loan (A)	**1,689.2**	
Term Loan (long term; fund based)	1,689.2	[ICRANP] LB+; Assigned
Fund-based facilities; Short term loans (B)	**35**	
Bridge gap loan (within the term loan)	(170)	[ICRANP] A4; Assigned
Working capital loan (short term; fund based)	35	[ICRANP] A4; Assigned
Non-fund-based facilities; short term loans (C)	**8.2**	
Letter of Credit (within the term loan)	(540.119)	[ICRANP] A4; Assigned
Bank Guarantee	8.2	[ICRANP] A4; Assigned
Total (A+B+C)	**1,732.4**	

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About ICRA Nepal Limited

ICRA Nepal Limited, the first Credit Rating Agency of Nepal, is a subsidiary of ICRA Limited (ICRA) of India. It was licensed by the Securities Board of Nepal (SEBON) on October 3, 2012. ICRA Nepal is supported by ICRA Limited through a technical support services agreement, which envisages ICRA helping ICRA Nepal in areas such as rating process and methodologies, analytical software, research, training, technical and analytical skill augmentation.

Our parent company, ICRA Limited, was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies.

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