Nepal Electricity Authority: Rating reaffirmed

October 09, 2023

Summary of rating action

Facility	Rated Amount (NPR million)	Rating Action
Issuer Rating	NA	[ICRANP-IR] AA+; reaffirmed

Rating action

ICRA Nepal has reaffirmed the issuer rating of **[ICRANP-IR] AA+** (pronounced ICRA NP issuer rating double A plus) to Nepal Electricity Authority (NEA or the entity). Issuers with this rating are considered to have a high degree of safety regarding timely servicing of financial obligations. Such issuers carry very low credit risk. The sign of + (plus) or – (minus) appended to the rating symbol indicates the entity's relative position within the rating categories concerned. The rating is only an opinion on the general creditworthiness of the rated entity and is not specific to any debt instrument.

Rationale

The rating continues to factor in the sovereign ownership and strategic importance of NEA for the Government of Nepal (GoN) as major implementing agency in energy sector development, sole entity involved in transmission, distribution and cross-border power trade as well as key player in energy generation with installed capacity of ~1,100 MW (including subsidiaries/associates). NEA's importance to GoN is also reflected in the latter's support to NEA through yearly budgetary allocations, equity injections (through cash or interest/principal capitalisation) and other requisite funding/operational support, which provides major comfort to the rating action. Till now, NEA's entire standalone borrowings have been from GoN that liaises with international lending agencies (like ADB, World Bank, etc) for sourcing debt as well as serving them on behalf of NEA; without imposing structured repayments on NEA. ICRA Nepal expects the continuation of similar support to NEA going forward as well. The assigned rating also continues to take comfort from the long track record of the entity (since 1985) and its experienced board/management team.

The rating also continues to take comfort from NEA's good financial profile underpinned by healthy revenue growth from energy sales. NEA's profit in FY2023 was affected by relative moderation in energy demand growth as well as lower generation by domestic projects (both NEA owned and IPPs) which had to be replaced through relatively expensive energy import. However, gradual replacement of energy imports through relatively cheaper domestically generated/purchased energy and year-on-year decline in system losses augurs well for NEA's long-term profitability. Going forward, import substitution is likely to be aided by gradual expansion/upgradation in transmission network being made by NEA, connecting current and future projects across different river-basins in different regions to the national grid through high-capacity transmission lines. Commissioning/expansion and upgradation of cross-border transmission infrastructure is also likely to enable NEA to improve grid stability as well as optimize profitability.

Nonetheless, the rating is constrained by sizeable capital commitments of NEA towards the ongoing upgradation/reinforcement of transmission and distribution infrastructures which could keep NEA's liquidity under pressure over the medium term. The rating also takes note of the execution risks for the projects under NEA's subsidiaries/associates, which can result in cost and time overrun, thus impacting the cost competitiveness while increasing NEA's capital commitments. Guarantees given to the lenders against the debts used by subsidiaries/associates could also stress NEA's liquidity in the event of non-payment by subsidiaries/associates. With gradually increasing domestic energy generation capacity and large number of domestic projects in the pipeline with firm PPA with NEA, its ability to identify and grow the domestic as well as export market will remain essential to prevent energy spill-over and ensure NEA's future profitability. The rating also takes note of lack of demonstrated track record of regular debt repayment by NEA as the GoN has not enforced strict structured repayments. Amid the budgetary pressures on GON in recent years and the possibilities of reduced budgetary allocation/liquidity support, NEA's liquidity management practices offer scope for improvement going forward. Collection of long-pending receivables against dedicated feeder charges, billed by NEA in FY2020 and uncollected-till-date will also remain a monitorable for NEA's near to medium term liquidity profile.

Going forward, timely and adequate financial support from GoN to NEA will remain a key rating monitorable and sensitivity given the sizeable capex plans of NEA for grid strengthening over the medium to long term. NEA's long-term financial profile and profitability will depend on NEA's ability to secure demand from domestic and foreign market commensurate with the capacity under development, substitute/optimize energy imports and control system losses. Since the current ratings remain underpinned by the strategic importance of NEA to GON, any moderation in the linkages/support/strategic importance of NEA would also remain the key rating sensitivities.

Key rating drivers

Credit strengths

Sovereign ownership, seasoned management, and NEA's strategic importance to the GoN – NEA is fully owned by the GoN and is the sole public sector undertaking (PSU) in the Nepalese power transmission and distribution sector. NEA has major involvement in energy generation (directly as well as through subsidiary/associate SPV) and is the only entity with the mandate for domestic as well as cross-border power trading. NEA's board of directors has strong representation from GON Ministries (mainly Energy and Finance) while its management team comprises seasoned individuals from the power sector.

With NEA's projects (including the subsidiaries/associates) accounting for significant portion of domestic energy production and given NEA's monopoly in transmission, distribution, and cross-border energy trading, NEA remains strategically important to the GoN. Accordingly, NEA has been receiving adequate funding support from GON for the capital investments required across the generation, transmission, and distribution (GTD) functions; mainly in the forms of budgetary allocations as well as conversion-to-equity of certain loans/interest payables in the past. However, any moderation in linkages between NEA and GON will remain a rating monitorable and sensitivity.

Good revenue growth, margin moderation in FY2023 caused by higher reliance on energy import – NEA's revenues remain in an increasing trend, supported by growth in domestic demand and energy exports (NEA has been selling energy up to 632MW to India via bilateral agreements and Indian energy exchange[1]). Export revenues accounted for 10% of NEA's revenue in FY2023 vs 5% in FY2022. While the moderation in demand growth in FY2023 remains a concern, the long-term demand can be expected to grow given NEA's focus on grid strengthening and expected improvement in reliability and quality of power supply across the country. Policy level development (mainly bilateral agreements with India) to augur long-term export prospects also remains a positive for NEA over the long-term.

During FY2023, NEA imported higher energy due to reduced domestic generation, which affected NEA's operating margins**.** The replacement of cheap domestic energy with expensive imports affected FY2023 margins, as the increased cost could not be passed to the customers amid the controlled energy tariff. However, with gradual growth in domestic energy production and gradual reduction in annual energy imports, NEA's long-term margins are likely to remain healthy. Till FY2021, one third of the overall available energy was met through imports from India which has reduced to ~14/15% in FY2022 and FY2023 (mainly supported by commissioning of 456MW Upper Tamakoshi). Going forward, the commissioning of new domestic projects (especially the large projects under NEA's subsidiaries such as 111 MW Rasuwagadhi HPP and 102MW Madhya Bhotekoshi HPP) could further lower import reliance which is expected to benefit NEA's financial profile.

Satisfactory leverage levels in relation to debt pertaining to operational projects – NEA has a sound financial profile with comfortable capitalisation profile (gearing of <1x, TOL/TNW (Total outside liabilities/total net worth) of 1.4x as at mid-July 2023) that remains supported from the periodic equity infusion by the GoN and in the form of capitalisation of interest/principal. Though NEA had a sizeable outstanding debt of ~NPR 219 billion which reflects in a total debt to OPBITDA of ~10 times as at mid-July 2023, a major chunk of these loans pertains to under-construction projects, with the debt relating to operational and partially operational projects standing much lower, giving rise to comfortable operational debt to OPBITDA. This also offers comfort to the incremental debt/OPBDITA, once all projects come into operation. Rating comfort also arise from the fact that major portion of the debts are sourced from the GON that doesn't enforce structured repayment obligations on NEA.

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[1] Exports are done during wet (monsoon) season while during the dry season energy is imported from India. Till FY2023, Nepal remains a net energy importer on annualized basis.

Credit challenges

Structured debt servicing track record yet to be established – NEA's entire standalone borrowings is from GoN which has not defined a structured repayment for NEA. NEA's payment to GoN against these borrowings are made on the basis of ad-hoc demand raised by the latter. However, with the establishment of Public Debt Management Office by GoN in December 2018 and few debt-funded capex program on the verge of completion, NEA is likely to have structured debt repayment obligations over the medium to long-term. Therefore, NEA's ability to improve the liquidity management practices enabling timely servicing of structured debt will remain a rating sensitivity. Recent pressure on GoN's budget and the possibility of reduced budgetary/non-budgetary support from GoN is also likely to necessitate better liquidity management by NEA going forward.

Increased working capital intensity, sizeable capex plans to pressurise liquidity over medium term – Along with the growth in operating income, NEA's working capital intensity has also increased in FY2023. While the collection of energy bills from the customers remains satisfactory, the spike in debtor days due to the booking of dedicated tariff receivable in FY2020 remains a major contributor to the high working capital level for NEA. In FY2023, the spike in inventory levels (for repair, maintenance, and overhaul of NEA's projects) also contributed to the elevated working capital intensity.

Similarly, since NEA has been undertaking sizeable projects across GTD functions (average annual investment of ~NPR 35-40 billion each year) utilizing its internal accruals, which has been pressurizing NEA's short-term liquidity. NEA's ability to secure funds to cover its major capex commitments will therefore remain crucial.

Execution risks for projects under subsidiaries/associates – Over the last two decades, NEA has been developing new hydropower projects under special purpose vehicles (SPV), as opposed to in-house development in the past. As of now, there are ~13 subsidiary companies and ~8 associate companies under NEA, and these projects are in various stages of development and given the past trends, sizeable time and cost escalations is likely to occur across these projects. Given the inherent project execution risks in hydropower projects, the possibility of increased funding support from NEA to those projects remains a possibility (>100% cost overrun in Upper Tamakoshi Hydropower project).

Regulatory risks – The regulation of power sector was started with the introduction of Nepal Electricity Regulatory Commission Act in 2017. The Electricity Regulatory Commission (ERC) was thereafter established to regulate generation and transmission of electricity, along with fixing tariffs and implementing a National Grid Code to govern the power sector in the country. Hence, NEA's revenue profile is now exposed to regulatory and exogenous factors such as downward revision in electricity tariff, change in project build-up modality (Q factor), power trade issues, etc.

Evolving accounting practices and financial policies – NEA's auditors (Office of the Auditor General) have expressed qualified opinion over FY2022 financial statements over issues such as lack of fair and appropriate presentation of carrying amount across revenue, assets, and liabilities heads. Issues regarding receivable reconciliation/debtor confirmation (related to dedicated feeder tariff), etc have also been raised. The ultimate resolution of the same could have an impact on NEA's financial profile.

Links to the previous rating rationale:
Rationale_Nepal-Electricity-Authority_Fresh-Issuer-Rating_Feb-2022

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

Links to applicable criteria:
Issuer Rating Methodology

About the entity

Incorporated on August 16, 1985, Nepal Electricity Authority (NEA) is the entity involved in generation, transmission, distribution, and trading of power in the country. NEA is fully owned by the Government of Nepal and operates under a specific statute viz. Nepal Electricity Authority Act 1984.

On a standalone basis, NEA reported an operating revenue of ~NPR 110 billion during FY2023 comprising ~NPR 100 billion towards sale of electricity and ~NPR 10 billion towards other income (mainly surcharge on delayed payment by customers). NEA's equity capital was ~NPR 198 billion while its net worth was ~NPR 243 billion as at mid-July 2023.

Key Financial Indicators (standalone NEA financials)

Amount in NPR million	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Indicators	**Audited**					**Provisional**
Operating Income (OI)	58,753	71,398	76,076	78,741	97,265	109,819
Profit After Tax	3,732	9,771	11,828	6,060	14,275	10,470
OPBITDA/OI (%)	13.3%	19.6%	25.4%	21.5%	28.1%	20.4%
ROCE (%)	6.2%	10.0%	10.1%	5.5%	8.9%	7.2%
Total Debt/Tangible Net Worth* (TNW)	1.52	1.14	1.13	1.04	1.05	0.93
Total Outside Liability/TNW (times)	2.62	1.88	1.78	1.62	1.61	1.41
Total Debt/OPBITDA (times)	15.44	9.70	8.58	10.81	7.56	9.90
Interest Coverage (times)	2.37	3.52	4.26	3.09	4.57	3.70
Net Working Capital/OI (%)	27%	23%	42%	50%	41%	50%

**Excludes revaluation reserves*

Analyst Contacts

Mr. Sailesh Subedi (Tel No. +977-1-4419910/20)
sailesh@icranepal.com

Mr. Rajib Maharjan (Tel No. +977-1-4419910/20)
rajib@icranepal.com

Mr. Purushottam Sedhai (Tel No. +977-1-4419910/20)
purushottam@icranepal.com

Relationship Contacts

Ms. Barsha Shrestha (Tel No. +977-1-4419910/20)
barsha@icranepal.com

About ICRA Nepal Limited

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For more information, visit www.icranepal.com

ICRA Nepal Limited,
Sunrise Bizz Park, 6th Floor, Dillibazar, Kathmandu, Nepal.
Phone: +977 1 4419910/20
Email: info@icranepal.com
Web: www.icranepal.com