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POWER

13 February 2024

CERC draft tariff norms: Balancing risk-reward

- **New draft tariff norms ensure stability of existing power assets and recognise risk-reward across asset classes**
- **Proposals are positive for hydro projects and clearly aimed at boosting storage capacity for renewable RTC power**
- **PSU utilities still offer valuation comfort; we maintain BUY on NTPC and PWGR while TPW remains at HOLD**

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New norms signal policy stability: The new draft tariff norms released by the Central Electricity Regulatory Commission (CERC) for the period FY25-FY29 ensures the stability of existing power assets by keeping their regulated returns unchanged. It also recognises risk-reward across power asset classes by proposing additional returns for pumped and storage-based hydro projects while marginally lowering returns for transmission assets.

Boost to hydro power: The proposed tariff guidelines maintain 15.5% ROE for thermal generation stations over FY25-FY29, in line with current norms (FY19-FY24). CERC has given a fillip to hydro-based power by hiking ROE 50bps to 17% for storage-based hydro plants as well as pumped storage hydro plants (PSHP). This is clearly aimed at driving investments for storage capacity as PSHP is a viable solution to make renewable power available round the clock (RTC). On the transmission side, CERC has marginally reduced regulated ROE by 50bps to 15%.

Coverage stocks likely to be largely unaffected: We expect the new proposals to have little impact on our coverage universe as the regulated ROE on NTPC and TPW's generating assets remains the same, whereas PWGR could see a marginal negative impact as the bulk of its new capex is earmarked for tariff-based competitive bidding (TBCB).

Public utilities still offer valuation comfort…: Power stocks have rallied in the past three months, with the BSE Power index up ~50% and both public and private sector utilities showing strong gains. However, the valuation gap between the two is still 60%, with the average TTM P/B of major private players at 3.2x vs. 2.1x for PSUs. This gap rises to ~100% if we exclude CESC which has been a relative underperformer. Given their pedigree and track record, we see no reason why NTPC and PWGR should not enjoy valuations closer to private sector peers.

…NTPC and PWGR remain our top picks: The valuation comfort in PSU stocks leads us to retain our BUY ratings on **NTPC** (TP Rs 370) and **PWGR** (TP Rs 320) – our top picks in the utilities space.

Recommendation snapshot

Ticker	Price	Target	Rating
NTPC IN	316	370	BUY
PWGR IN	270	320	BUY
TPW IN	1,131	1,140	HOLD

Price & Target in Rupees | Price as of 12 Feb 2024

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Fig 1 – Draft CERC norms on ROE – Stable for generation, boost for new hydro projects

Basis	Old	New
ROE on existing thermal, transmission and run-of-river hydro projects	15.50%	15.50%
ROE on existing storage type hydro generating stations, PSPs and run-of-river hydro project with pondage	16.50%	16.50%
ROE on existing thermal and run-of-river hydro projects	15.50%	15.50%
ROE on new transmission projects commissioned	15.50%	15.00%
ROE on new storage type hydro generating stations, PSPs and run-of-river hydro project with pondage	16.50%	17.00%
ROE on additional capitalisation after cut-off date beyond the original scope	Weighted average rate of interest on actual loan portfolio	1Y MCLR of SBI + 350bps (ceiling of 14%)
ROE reduction upon failure to achieve required ramp rate	0.25%	0.25%
Additional ROE allowed upon incremental 1% ramp rate over required ramp rate achieved	0.25% (ceiling 1%)	0.25% (ceiling 1%)
Ramp rate required	1% per minute	1% per minute (coal or lignite fired plants), 3% per minute (gas power plants), 10% per minute (hydro power plants)

Source: CERC, BOBCAPS Research | PSP: Pumped Storage Plant

Fig 2 – Working capital – Most conditions have been retained

Basis	Old	New
Cost of coal or lignite (pit-head)	10 days	10 days
Cost of coal or lignite (non-pit-head)	20 days	20 days
Cost of limestone	10 days (pit-head) and 20 days (non-pit-head)	15 days
Advance payment towards cost of coal or lignite and limestone	30 days	30 days
Cost of secondary fuel	2 months	2 months
Maintenance spares	20% of O&M expenses	20% of O&M expenses
Receivables	45 days of capacity charge and energy charge	45 days of capacity charge and energy charge
O&M expenses	1 month	1 month
Emission control system of coal or lignite-based thermal generating stations:		
Cost of limestone or reagent	-	20 days
Advance payment towards cost of reagent	-	30 days
Receivables	-	45 days of supplementary capacity and energy charges
O&M expenses	-	1 month
Maintenance spares	-	20% of O&M expenses
For open-cycle gas turbine/combined cycle thermal generating stations:		
Fuel cost	30 days	15 days
Liquid fuel cost	15 days	15 days
Maintenance spares	30% of O&M expenses	30% of O&M expenses
Receivables	45 days of capacity charge and energy charge	45 days of capacity charge and energy charge
O&M expenses	1 month	1 month
For hydro generating station including pumped storage stations and transmission systems:		
Receivables	45 days of annual fixed cost	45 days of annual fixed cost
Maintenance spares	15% of O&M expenses	15% of O&M expenses
O&M expenses	1 month	1 month

Source: CERC, BOBCAPS Research

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Fig 3 – O&M expenses – Proposed escalation of expenses a positive

Basis	Old	New
Emission control systems in coal or lignite-based thermal generating station	-	2% of admitted capex, to be escalated at 5.89% annually
Escalation rate to be applied on hydro projects with less than 3 years of operation	4.77%	5.86%
Communication system in transmission systems	2%	2%

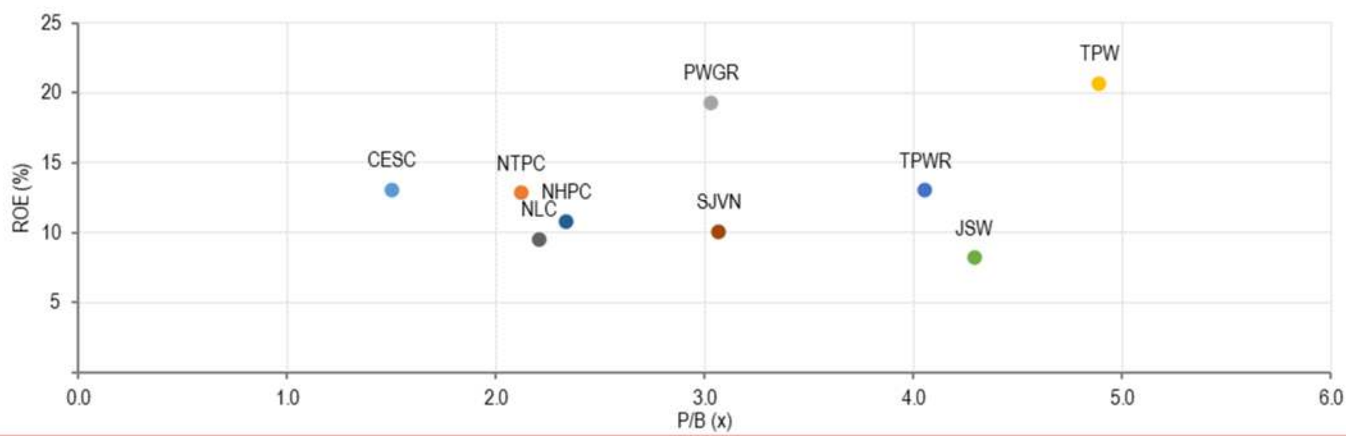
Source: CERC, BOBCAPS Research

Fig 4 – Input prices of coal and lignite from integrated mines have been included

Basis	Old	New
Input price of coal and lignite from integrated mines	Not in scope	In scope
ROE for the integrated mine	-	14%
Salvage value of asset	-	5%
O&M expenses escalation	-	5.89% annually
Working capital coverage:		
Input cost of coal stock	-	7 days of production
Consumption of stores and spares	-	15% (coal mine) and 20% (lignite mine)
O&M expenses	-	1 month

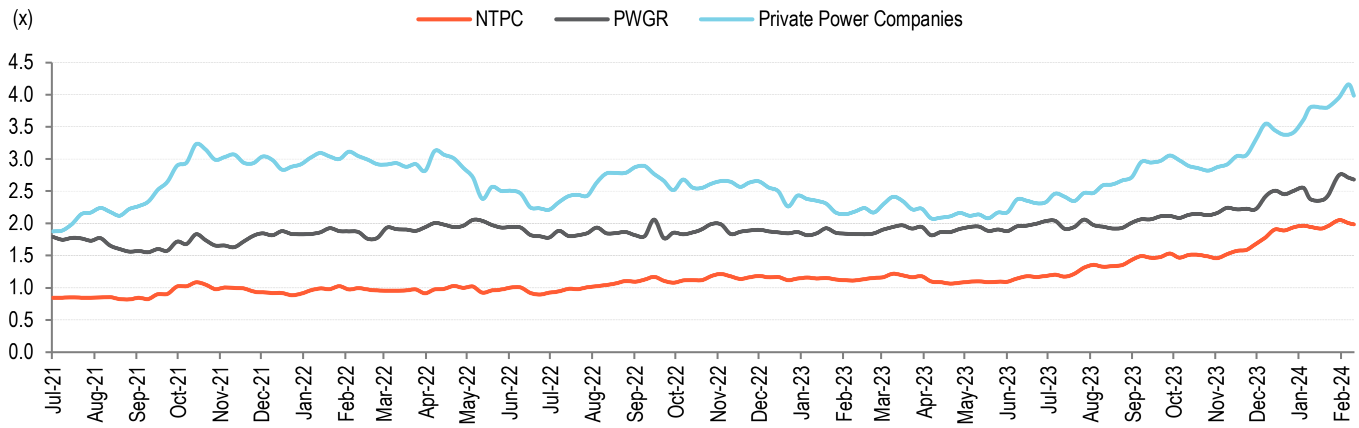
Source: CERC, BOBCAPS Research

Fig 5 – PSU companies trading at lower P/B despite higher ROEs



Source: Bloomberg, BOBCAPS Research

Fig 6 – P/B: Gap between private and public sector utilities expected to narrow



Source: Bloomberg, BOBCAPS Research

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Note: Recommendation structure changed with effect from 21 June 2021

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