BRIDGE TO INDIA

Bad habits haunt the RE sector

For more than 2 years, there have been persistent concerns that aggressive bidding in solar auctions is storing up trouble for the sector. Fortunately for the sector and the winning bidders, equipment costs kept falling more sharply than market expectations - 20% and 25% in 2015 and 2016 respectively.

Developers have ridden the wave of falling costs and project delays to make handsome profits. Example – at the time of bidding in Madhya Pradesh 300 MW tender in Q2 2015, module cost was USD 0.52/ Wp. Using this cost and median winning tariff of INR 5.35/ kWh gives us a project IRR of 13%. But by Q4 2016, when some developers actually constructed projects stretching time limits under the tender, module costs had fallen by over 30% and actual project IRR was up to 18%.

Unsurprisingly, bidding has become increasingly more aggressive over time. It is now standard industry practice to bid based on anticipated fall in costs. Analysis of Bhadla auction in May 2017 suggests that to achieve a project IRR of 12%, developers were banking on module costs falling to USD 0.22/ Wp. The aggressive behaviour has been worsened by slowdown in tenders making developers desperate to win projects at any cost. In our report titled, Analysis of utility scale solar tenders in India, we stated, “Low equity IRRs suggest that the Indian developers, in particular, are not pricing risks fully and too much faith is being placed on everything turning out positive. The sector has been very lucky with rapid falls in solar module prices easing most of the financial and execution challenges. Any dislocation in module supply chain or even a price stabilization will spell trouble for winning bidders.”

Indeed, module costs have inched up to USD 0.36/ Wp today (+20% over 6 months), when developers were assuming that costs would fall to USD 0.25/ Wp or even lower by this time. Unfortunately, that’s not all. GST implementation has increased total project costs by about 5% and developers are further forced to bear import duties of 7.5% on modules. There is also a tangible threat of anti-dumping duties. The result is that projects allocated in the last six months (Bhadla 750 MW, NTPC 250 MW, Tamil Nadu 1,500 MW, Gujarat 500 MW) are facing an uncertain future. Our calculations suggest that based on today’s cost levels, project level returns are down to low single digits in an optimistic scenario.

This challenge is not restricted to solar power sector. As wind moves to a competitive auction regime, it inevitably faces the same concerns. Could RE suffer the same fate as thermal power or roads, where irrational pricing led to many projects being abandoned or financially distressed? Our estimation is that because of their short gestation period, well-capitalized sponsor groups and relatively small project sizes, most RE projects will come online as planned. But investors will be praying for significant reduction in costs in 2018 and delays are highly likely. We also feel that the lenders will exercise sufficient caution ensuring that they are largely protected from any downside.