PPP in coal: The next big thing!

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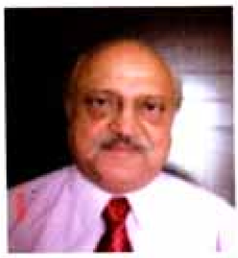


In the wake of the recent announcement by the Ministry of Coal (MoC) for allocation under rule 4(3) of the "Auction by Competitive Bidding of Coal Mines Rules 2012" to allot 17 Coal blocks (14 for power and 3 for mining) to public sector companies , a lot of excitement has been generated in the coal sector. It is generally believed that this move will ensure a fair and transparent system of allocation of coal blocks besides giving a much needed boost to the sector.

Coal as of now in India is an extremely valuable resource and the most important source of energy. As of now, it accounts for more than 50 percent of the energy requirements of the country.

Scaling-up challenges in general for other forms of energy, and more particularly high capex for solar, environmental issues for hydro, round the year non-availability for bio-mass, policy bottlenecks for gas, etc. make us highly vulnerable and dependent on coal as an energy source.

While this is as much a known fact to us as is to the Government of India, precious little is being done to open up the sector for global players and private participation which would bring in risk capital and global best practices, thereby facilitating fast-track development of coal assets. Coal as a sector is the most neglected in terms of policy reforms, and one of the handful of sectors that are still highly regulated.

Indian coal sector still at early stage after 250 years

The Indian coal sector would be completing around 250 years of mining history since coal was first dug out in the Raniganj Coalfield in 1774. Coal, therefore, as an industry is probably as old as the telecom (which is more than 200 years old), automobile (which is more than 70 years old) and the banking sector (which is in practice in India for more than 225 years). However, while telecom, automobile and banking have attained maturity in the life-cycle, coal is still at a start-up phase. The USA, Australia and South Africa are matured economies in terms of the coal sector, while China, Indonesia, Russia, Mongolia and Africa (other than South Africa) are in the mid growth phase. India in comparison to these countries is still at the early stage in the industry life-cycle.

Indian coal sector growth

As on April 1, 2012, India's coal resources stood at 293 billion tons (source: MoC). Of these, only 118 billion tons are under Proved category which can be mined. The rest are under indicated and inferred category implying that substantial exploration is required to convert these resources into Proved category before they could become commercially exploitable. It is anticipated, according to the Working Group of Coal and Lignite for the Twelfth Five Year Plan (2012-17) that the country's production in 2016-17, the terminal year of Plan period, will be 715 million tons (mt) and the demand 980.50 mt (CAGR = 5.1 percent), leaving a gap of 265 mt. The situation is pretty grim and importing coal appears to be the only solution as of now to meet our production shortfalls, thereby causing a heavy burden on the exchequer, and more alarmingly increasing the current account deficit. During the period 2011-12, India imported coal worth around ₹70,000 crore which is more than Coal India Limited's (CIL) top line in value terms (₹62,415.43 crore) for the same period. As if this was not enough, it would be almost double the CIL top line by the end of the Twelfth Five Year Plan (2016-17). India has to gear up to bridge this ever widening gap between demand and supply by increasing production indigenously. One of the ways ahead could be the PPP route.

Private participation & PPP: The way ahead

Private participation and public private partnership (PPP), which are not necessarily

the same thing, could be one of the ways to ramp up coal production in the country by 10 percent year-on-year (yoy) and take India towards self-sufficiency.

The Government of India describes PPP as a partnership between a public sector entity (sponsoring authority) and a private sector entity (a legal entity in which 51 percent or more equity is with the private partners) formed for the creation and/or management of infrastructure for public purpose for a specified period of time (concession period) on commercial terms and in which the private partner has been selected through a transparent and open system.

PPP experiences in Indian coal sector

A number of leading state government mining companies such as Madhya Pradesh State Mining Corporation (MPSMC), Maharashtra State Mining Corporation (MSMC) and Maharatna public sector units (PSU) like Steel Authority of India Limited (SAIL) have successfully adopted the PPP model for fast-tracking development of coal blocks allotted to them through the government dispensation route. The innovative structuring of the PPP models for these companies and selection of Joint Venture partners through a fair and transparent bidding process was done by aXYKno Capital Services Ltd, a leading consulting powerhouse in the natural resources and energy sector in India. These bids have been run in a fair and transparent manner and this resulted in fast-track development of these blocks. The projects structured are within the existing regulatory framework and have created value-propositions for the government as well as the private entrepreneur and this has ensured fast-tracking of coal production. But, we feel more could be done if the sector is opened up further for risk capital.

Approach for structuring PPP transactions

(a) Pre-feasibility /detailed feasibility study of the coal block is the starting point.
(b) A structure/model based on the study is constructed to suit the 'sponsor' and the 'developer'.
(c) Detailed mine valuation running multiple scenarios and option analysis of the project is run to demonstrate adequate risk-reward and for structuring a robust bid.
(d) Selection of a strategic partner is accomplished through a fair and transparent bidding process.

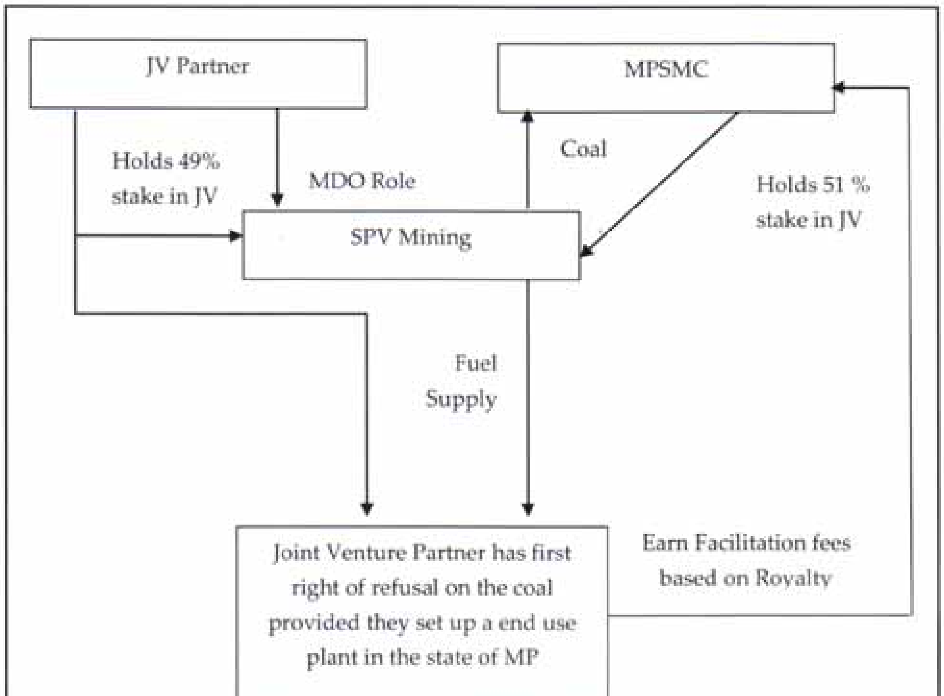
Case study

Presented below are two caselets successfully adopted by MPSMC and SAIL:

CASELET 1- Madhya Pradesh State Mining Corporation (MPSMC)

Coal Blocks: Bicharpur, MarkiBarka, Mandla South, Morga III, Morga IV, Semaria -Piparia.

(1) MPSMC is an enterprise owned and controlled by Government of Madhya Pradesh and engaged in the exploitation of different minerals.
(2) The model was developed within the PPP framework for the six coal blocks allocated to MPSMC by MoC through the government dispensation route.



Joint Venture Model

(3) The bidding parameter fixed here was a percentage over the royalty of grade D coal.
(4) The bidding was a huge success with more than 232 bids sold and 152 bids submitted with global and Indian players joining in.
(5) The successful bidder was the one who quoted the highest amount over the royalty of coal specified.
(6) The successful bidder (H-1) will form a Joint Venture company (JV) with MPSMC holding 49 percent stake while MPSMC will hold 51 percent share, thus retaining its majority stake in the JV. The qualified bidder (JV partner) forms a special purpose vehicle (SPV) for mining and supply of coal to the JV. The JV partner has the first right of refusal of coal provided he sets up an end use plant in the state of Madhya Pradesh.

MPSMC will earn facilitation fees based on royalty on per ton of extractable reserves. This would result in MPSMC earning profit before tax of around ₹850 crore annually for the mine life besides fast-tracking the development of the coal blocks.

CASELET 2: Steel Authority of India Limited (SAIL)

Coal Block: Tasra

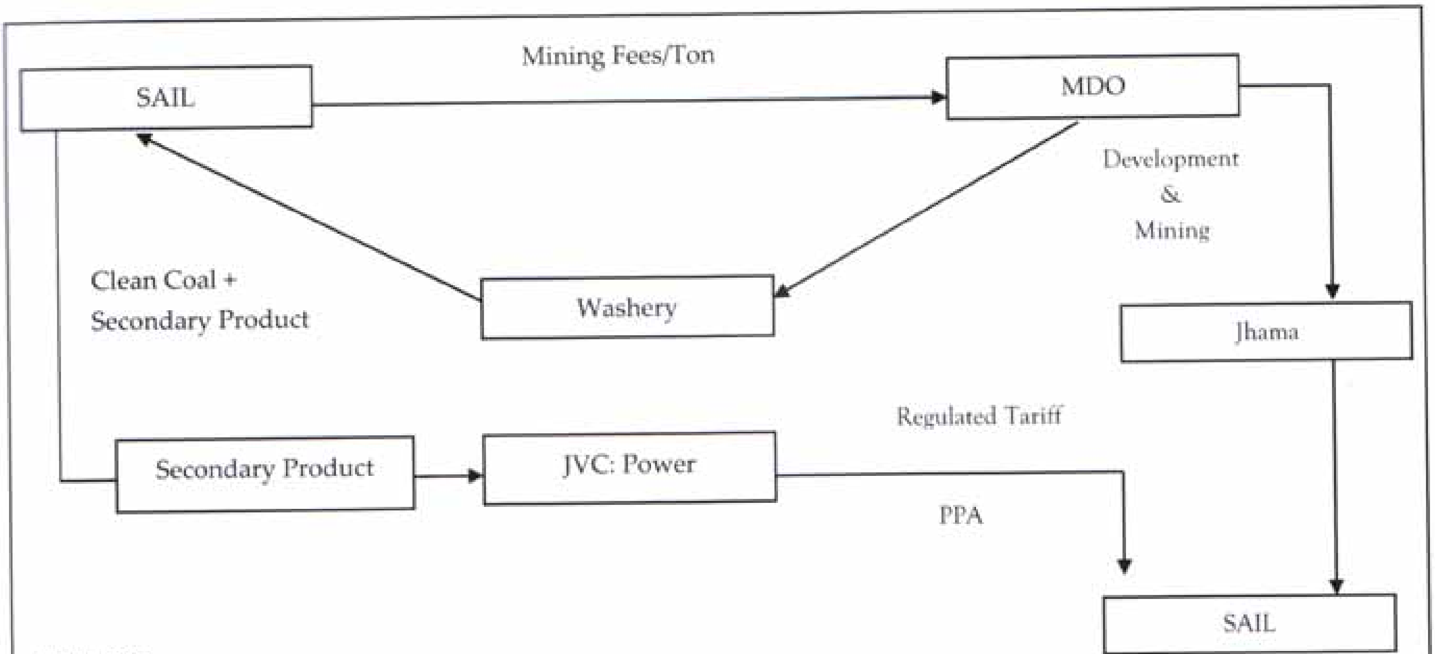
Model: MDO

SAIL is a Maharatna PSU and the leading steel maker in the country.
(1) SAIL had earlier made three attempts for selection of mine developer and operator (MDO) for mining its Tasra coking coal block located in the Jharia coalfield. However, the company could not succeed as the block had inherent problems of Resettlement and Rehabilitation (R&R) and land acquisition.
(2) The challenge was to develop a successful model for the development of the block which would not fail for the fourth time. It was felt that unless an incentive was given to the developer no financially sound party would participate. It was therefore decided that to make the model successful, incentive in the form of power generation from rejects would be offered to the MDO with majority stake in the Power JV with SAIL.
(3) The scope of work of the MDO was to develop and mine coal on mining fees per ton of coal extracted. The MDO would also set up a washery and the clean and secondary product would be handed over to SAIL.
(4) SAIL would set up a JV for power from the secondary product with the MDO. 80 percent of the power would be sold through a PPA to SAIL while the balance power would be sold on merchant basis as per regulatory norms with SAIL having first right of refusal.
(5) The bidding process has been successfully concluded, with global and Indian players evincing strong interest.

It can be seen from the above case studies that the PPP route has helped in fast-track development of coal blocks through selection of financially sound and technically competent Joint Venture partners/MDO. These models have brought huge financial gains to the companies. On commencement of mining from these coal blocks, around 25 million tons of coal is expected to be produced annually.

PPP vis-a-vis MDO

There is a common misconception that mining from coal blocks through PPP model and MDO route is similar. On the contrary, there is a vast difference between the two. While PPP is based on the principles of ownership and equal participation, the MDO would undertake mining of coal on a fixed cost per ton mining fees covering all activities of mine development till loading of coal in wagons, and is more a mode of private participation. At times, the scope of work of the MDO is enhanced to cover issues like preparation of mining plan, obtaining mining lease, obtaining forest and environment clearance, land acquisition, R&R etc. In other words, the MDO works like a contractor on a fixed mining fees and is penalised for shortfall in production. Thus there is very little incentive for the MDO since there is no ownership involved. On the other hand, PPPs should not be mistaken for privatisation but a contract that enables the government to retain majority control on the equity ownership (generally 51 percent share) in the Joint Venture company formed between the private and public sector. The PPP route thus creates a larger sense of commitment for the private partner since it owns a stake in the company. This results



Model: MDO

in fast-track development of the coal block ensuring timely completion of all milestone activities leading to commercial production of coal.

The PPP route is particularly effective for those government companies which are cash starved and do not have the financial strength to develop the coal blocks allocated to them through the government dispensation route. The PPP model if implemented judiciously can result in windfall gains for the state government mining and power companies since the private player is willing to offer upfront equity besides financial investments required for the development of the coal block. This can be seen from our caselet on MPSMC where Joint Venture partners have offered facilitation fees /upfront sweat equity besides financial investments to develop the coal blocks as Joint Venture partners.

If the MDO route is to be implemented successfully, there must be some incentive for the MDO. As illustrated in the caselet on SAIL, the incentive offered was in the form of power development. Thus a large number of financially and technically strong bidders participated in the bidding process for the coal blocks allotted to these companies as they would work as MDO for mining of coal and also form a JV company for setting up power plant and electricity generation on merchant basis as per the regulatory norms.

Bottlenecks for implementation of PPP

The MoC vide its notification dated December 27, 2012 has amended the "Auction by Competitive Bidding of Coal Mines Rules, 2012". In the Terms and Conditions of allocation of area containing coal for the purpose of mining and also for specified end use, it is clearly stipulated that the "Mining Lease shall be in the name of the allocate company and shall remain with a Government company and the formation of Joint Venture by such company with any private company shall not be permitted for development of areas containing coal allocated under these rules."

This in our opinion is a negative step by the government and detrimental to the development of the coal sector in India. On the contrary, Joint Venture participation should be encouraged so that the private sector can infuse its finances and technical strength to help the PSUs in speedy development of coal blocks.

Conclusions

(a) PPP model and more private participation is one of the key potential solutions to ramp up coal production in the country. This would facilitate large private sector investments in coal mining sector. However, it has to be implemented in its true spirit and must involve ownership. Then only can we expect to see the desired results from such a partnership.

(b) The Government of India has in the 2013 Budget announced that it will allow private firms to mine coal along with Coal India Limited under PPP initiatives. However, if the ownership of identified mines including coal lies solely with CIL and the private operator is only paid a fees, then this violates the spirit of PPP where two entities work as partners with joint ownership. If not, then this is indeed a very positive initiative taken by the government and shows its seriousness to increase production of coal in the country. The implementation of PPP on a large scale will give a much needed fillip to the Indian coal sector. ■

The author is a Director at a'XYKno Capital Services Ltd.

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