Coal Supply a never-ending problem

By Neeraj Menon and Lzafeer Ahmad

The Presidential Directive issued on April 3, 2012 was expected to assure power suppliers of coal from Coal India Limited (CIL). The directive and its implications have been discussed in detail in our earlier Viewpoint edition of May 8, 2012 - Presidential Directive to Ease Coal Supply?

The decree made it obligatory for CIL to enter into Fuel Supply Agreements (FSA) with power producers, undertaking a supply commitment of 80 per cent of the contracted quantity of coal required by the power producers. Additionally, to ensure that the supply commitment is adhered to, the FSA also contained a provision in relation to levying a penalty of 0.01 per cent of the value of the deficit committed supply of coal.

When the presidential decree was issued, the concern was about CIL actually meeting its supply commitment of 80 per cent and instead opting to pay penalty of 0.01 per cent. Given that the penalty was low, it was feared that the nominal penalty was not deterrent enough to ensure supply. An important aspect of the directive was that CIL was to enter into FSAs with power producers whose power projects were to be commissioned within the deadline of December 31, 2011 but the directive remained silent about those projects commissioned after January 2012 upto December 2015.

Challenges to FSA

The FSAs were under scrutiny both by CIL and the power producers. CIL’s stand was that the fuel supply commitment was in excess of its production capacity and that it would not be able to cater to the aggregate demand. As a result, CIL was pushing for lowering of the supply commitment from 80 per cent. On the other hand, the power producers were demanding for levy of a higher penalty in order to ensure that the supply commitments are adhered to by CIL. Also, due to increasing pressure from the power producers, in the first week of June 2012 CIL directed its subsidiaries to sign FSAs with power producers, whose power plants were to be commissioned after January 2012 but before December 2015. The signing of the additional FSAs would have only stretched CIL’s resources to meet the demand for coal.
No takers for FSA

The original FSA had a few contentious provisions, which were detrimental to the interests of the power producers. For instance, the FSA provided CIL the option of unilaterally calling for a review after five years and the sole power to terminate the agreement in case the review fails to bring the parties to a mutually agreeable ground. In addition, the penalty of 0.01 per cent for failure to meet the supply commitments was not going to prove beneficial to the power producers. One of the many opposers of the FSA was the National Thermal Power Corporation (NTPC). NTPC had declined to sign the fuel supply agreement for plants commissioned after December 2009, because the pact was lacking in commitment. On account of growing pressure on CIL to amend provisions of the FSA, the CIL board requested the Prime Minister's Office (PMO) for a review of the FSA since the FSA itself was a result of the original PMO backed presidential directive. The PMO has made some recommendations, which are believed to be acceptable to NTPC. These key recommendations have been discussed below.

Changes to the FSA

Some of the changes recommended by PMO include allowing CIL a lower fuel supply commitment of 65 per cent as against 80 per cent prescribed earlier, but with a much higher penalty of up to 40 per cent of the value of the deficit coal. The CIL board had earlier approved a 0.01 per cent penalty for signing FSAs with power producers with power projects to be commissioned by December 31, 2011. As per the new formula recommended by the PMO, CIL will now be required to pay a penalty of 20 per cent for supply levels up to 5 per cent below the agreed level (65 per cent) and 40 per cent if the supply levels falls below the 5 per cent mark. This compensation will be applicable for the first four years of the FSA. From the fifth year onwards, the compensation structure would be kept similar to the provisions in the FSAs applicable to power stations commissioned up to March 31, 2009, and fixed at 10 per cent at supply upto 5 per cent below the trigger level of 80 per cent, 20 per cent for supply from 5-10 per cent below trigger level and 40 per cent for supply more than 10 per cent below the trigger level.

While at first glance, the revision might seem to be making drastic changes to the existing FSA, however the revisions are in fact a systematic approach to achieving 80 per cent availability with a revised penalty. CIL had proposed that it be allowed to achieve 80 per cent supply availability in a phased manner over 5 years and not an immediate basis - meeting 65 per
cent of their coal requirement for the first three years and raising this quantity to 72 per cent in the fourth year before reaching the earlier agreed 80 per cent level in the fifth year.

**PMO recommendations – How binding?**

While the industry is optimistic about the PMO recommendations, it is to be seen to what extent the CIL board will adopt the measures recommended by the PMO. As opposed to the PMO, the presidential directive in relation to the business of CIL was of a more binding nature- the President of India being so vested with the power to make directions under Article 37 of Articles of Association of CIL in relation to business affecting public interest. However, the PMO is not vested with any such power. Since the PMO’s recommendations are not binding, it is not clear whether all the recommendations of the PMO are likely to be adopted. The CIL board is scheduled to meet on July 31, 2012 to take a final decision on the proposed changes to the FSA in light of the recommendations of the PMO.

**Modified FSA: a long-term solution?**

It seems that the government is looking at the wrong end of the problem considering the attention the FSA has been attracting in the past few months. CIL has maintained its stand citing low production levels on account of which it would not be able to meet the assured supply commitments. The lowering of the supply commitment from 80 per cent to 65 per cent to be gradually increased to 80 per cent by 2016 might offer the solution only if certain fundamental problems of the coal sector are addressed. CIL has explained that its production is affected essentially because of delay in environmental clearances, evacuation problems and law and order situations that hamper and delay mining. In fact, CIL has 56 spillover projects from the 11th five year plan and has plans for 69 new projects for the 12th plan with a target of 615 million tonnes for the terminal year as opposed to a production of 437MT last fiscal. This target can be achieved if bottlenecks due to environmental and forest clearances, land acquisition, law and order issues and evacuation problems are resolved. As a step forward to better evacuation facilities, three railway lines are being established in Jharkhand, Chattisgarh and Odisha, which would enable an evacuation of total of 150 MT of coal.

Demand for coal is only going to rise in the coming years and the only solution to the match the demand is to ramp up the production. Once the
production is adequate, then CIL may be well able to meet its supply commitments under the FSA.

*Neeraj Menon is a Counsel and Lzafeer Ahmad is an Associate with Trilegal.*