



cutting through complexity

Union Budget 2015

Inspiring confidence,
empowering change in India

Energy and Natural Resources

Post-budget sectoral point of view

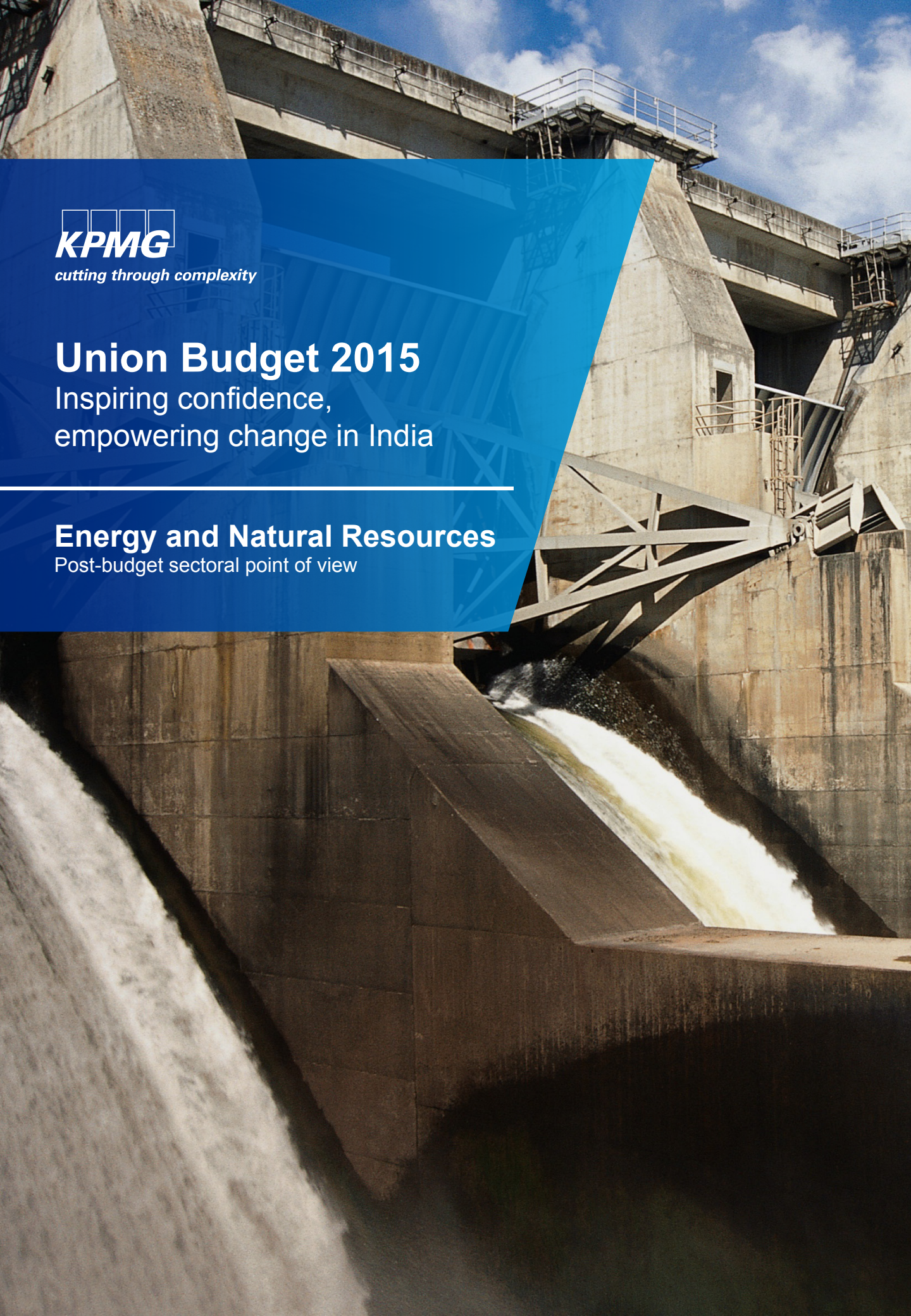




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“First comes thought; then organisation of that thought, into ideas and plans; then transformation of those plans into reality. The beginning, as you will always observe, is in your imagination.- Napoleon Hill”

Where are we

Elected in 2014, the NDA government excited the imagination of a whole generation, setting forth the promise of a new age economically empowered India. Providing affordable and reliable power to its people and to industry is critical to achieve this vision.

The energy sector of the country has been besotted with a legacy of multiple challenges. The power sector is split in a dichotomy of massive shortages and yet stranded/under-utilised capacities. Lack of integrated implementation of various segments, i.e. power generation, transmission and distribution has further aggravated the power supply situation. The natural gas production has reduced substantially over the last two years severely restricting utilisation levels of end use plants. Policy and regulatory issues, fuel shortages, slow pace of distribution side reforms and financial stress in the banking system on account of exposure to power assets are some of the key issues that require urgent resolution.

The government in the past year has undertaken multiple steps to address the key challenges in the sector and has set its growth agenda for the sector on the following key planks:

- **Power for all:** The government has embarked to provide 24X7 power for all by year 2019. Various schemes such as Deendayal Upadhyaya Gram Jyoti Yojana, Integrated Power Development Scheme have been launched to enable electrification and supply at the grassroots
- **Enhancing Coal output:** The government has set a target of enhancing coal production of Coal India Limited (CIL) to one billion tonne per annum by 2020
- **Focus on Renewable Energy:** A 100 GW of solar and 60 GW of wind powered capacity is targeted by 2022
- **Increasing natural gas output:** A goal of enhancing domestic natural gas output by two-third of current production over next five years is set

What was expected?

Achieving these goals would be feasible only if the investment cycle in the sector is reignited. The key expectations from the budget were:

- A concrete and time bound revival plan for stranded/ under-utilised power generation capacities
- Improving availability and cost of funds: provide priority sector lending status; enhance tax rebates for infrastructure bonds
- Exemption from Minimum Alternative Tax for infrastructure projects availing tax holiday under Section 80 IA
- Provide a complete pass-through status to Infrastructure Investment Trusts
- Enhanced fiscal and policy support to renewables: funding of the large target- creation of a sovereign debt hedge fund, allocation of higher budgetary support to roll-out solar project pipeline
- Roadmap for greater PPPs in power transmission
- Plan for implementing a step function growth for exploitation of coal and domestic natural gas resources
- Budgetary support for creation of corridors for evacuation of fuel to end-use plants.

Key policies/fiscal and tax proposals



Policy announcements

- The government has proposed creation of a National Investment in Infrastructure Fund (NIIF) towards which an annual allocation of INR200 billion is proposed. The NIIF would invest in equity of various infrastructure finance companies
- The public sector investment on infrastructure projects is proposed to be increased by INR700 billion in FY 2015-16 over FY 2014-15, and will be sourced from the centre's funds and resources of Central Public Sector Enterprises
- A reiteration of the renewable energy power generation capacity of 175,000 MW by year 2022 was made. The breakdown of this targetted generation capacity includes 100,000 MW of solar, 60,000 MW of wind, 10,000 MW of biomass, and 5,000 MW of small hydro
- The government proposes to award five Ultra Mega Power Projects of 4000 MW each under the Design, Build, Finance, Operate, and Transfer (DBFOT) route. The projects are proposed to be executed on a 'Plug and Play model i.e. before awarding these projects through a transparent auction system to developers, the government will secure all clearances and linkages required for these projects
- The Government proposed to bring in a legislations to address contractual disputes- Public Contracts (Resolution of Disputes) Bill. The legislation would provide a framework for quick redressal of disputes in public private partnerships
- A Bankruptcy Code would be brought in to assist lenders in recovery proceedings
- The Government proposes to bring in a legislation to reform and bring consistency in regulations across sectors- Regulatory Reforms Bill
- It was mentioned that the government would revamp the Public-Private Partnership (PPP) model and shared that there is a need for sovereign to assume certain uncontrollable risks
- The Government has also proposed to electrify remaining 20,000 villages in the country by 2020 including electrification by off-grid solar power generation

Direct tax proposals

- Corporate tax rate proposed to be gradually reduced from 30 per cent to 25 per cent over the next four years from FY 2016-17 and certain exemptions and incentives to be rolled back in a phased manner
- Surcharge on Income tax increased from five per cent to seven per cent in case total income exceeds one crore rupees but does not exceed 10 crore rupees and from 10 per cent to 12 per cent in case total income exceeds ten crore rupees. Maximum effective tax rate in case of domestic corporates would increase from 33.99 per cent to 34.608 per cent
- Surcharge on Dividend Distribution Tax increased from 10 per cent to 12 per cent
- Sale of units of InvIT by the Sponsor, allotted in exchange of shares of Special Purpose Vehicle:
 - Long term capital gains exempt
 - Short term capital gains taxable at concessional rate of 15 per cent
- In line with internationally accepted norms, concept of Place of Effective Management ('POEM') introduced to determine residential status of a company in India
- GAAR implementation deferred by two years and to be applicable from FY 2017-18. GAAR would apply prospectively to investments made on or after 1 April 2017
- Clarity provided for taxability on indirect transfer. Scope of 'substantial interest' for indirect transfer of assets specified as assets in excess of INR10 million and assets based in India represent more than 50 per cent value of the total asset value
- In case of new plant and machinery acquired and put to use for less than six months by a company engaged in the business of manufacture or production of any article or thing or in the business of generation or generation and distribution of power, balance 50 per cent of additional depreciation to be allowed in the next year.



Indirect tax proposals

- Bank guarantee/ fixed deposit required for availing customs duty exemption allowed to Provisional Mega/ Ultra Mega Power Projects has been extended from 36 months or more to 66 months
- In case of supply of goods against the International Competitive Bidding, to avail excise duty exemption, meeting the requirements as per the Customs laws (which entitles exemptions from customs duty) has been made mandatory
- Clean Energy Cess on coal, lignite and peat has been increased from INR100 per tonne to INR200 per tonne. The revenue generated from this cess is proposed to be spent on financing clean environment initiatives
- The Central Excise Duty rates of Petrol and Diesel (both branded and unbranded) have been revised to the extent of subsuming Education cess with no impact on total incidence on the overall Excise duties levied on the said products
- The effective rates of Additional Duty of Customs (commonly known as 'Road Cess') on Imported Motor Spirit (commonly known as 'Petrol') and HSDO, increased from INR2 per litre to INR6 per litre
- Ambit of Service tax expanded to cover all Government services provided to business entities (vis-à-vis support services covered earlier). As a consequence, there may be a potential service tax incidence on government's share of revenue in Production Sharing Contracts ('PSC').

Recent policy updates

Coal mines (Special provisions) ordinance

Government promulgated an ordinance to facilitate auction/ allocation of 101 of the 204 coal blocks that were de-allocated by Supreme Court of India in September 2014 to the end use sectors such as power, steel, cement, etc. Of these 101 coal blocks, 65 will be auctioned and 36 will be allocated to state entities. The bidding process for coal block allocation started on 22 January 2015 and the Government has already completed bid process for 18 coal blocks, which is expected to yield nearly INR1000 billion of cumulative royalty for the resource bearing states.

Proposed amendments to electricity Act of 2003

Ministry of Power has recommended amendments in the Electricity Act 2003 and has submitted its report with recommendations to the parliament for approval. Key amendments include thrust on development of renewable energy sector including stricter implementation of renewable energy purchase obligations, introduction of multiple distribution licensee, introduction of renewable generation obligation (RGO), separation of content and carriage business, and mandatory access for buyers with a load of more than one MW.

De-regulation of diesel prices

Pricing of diesel has been de-regulated by the Government in Oct 2014. Diesel prices will now be linked to the prevalent prices of India's crude oil basket and on a fortnightly basis, oil marketing companies will review and accordingly increase or decrease the price of diesel.

Revision in prices of NELP gas

Government in October 2014 revised prices of natural gas produced from oil and gas blocks auctioned under NELP from USD4.2 per mmbtu to USD5.61 per mmbtu. The government approved the modifications made to the Rangarajan formula approved by the previous government and revised the natural gas prices from suggested USD8.4 mmbtu to USD5.61 mmbtu. The new formula has been effective since 1 November 2014 and will be next revised on 1st Apr 2015 and then will be revised every six months.



Deendayal upadhyaya gram jyoti yojana (DDUGJY)

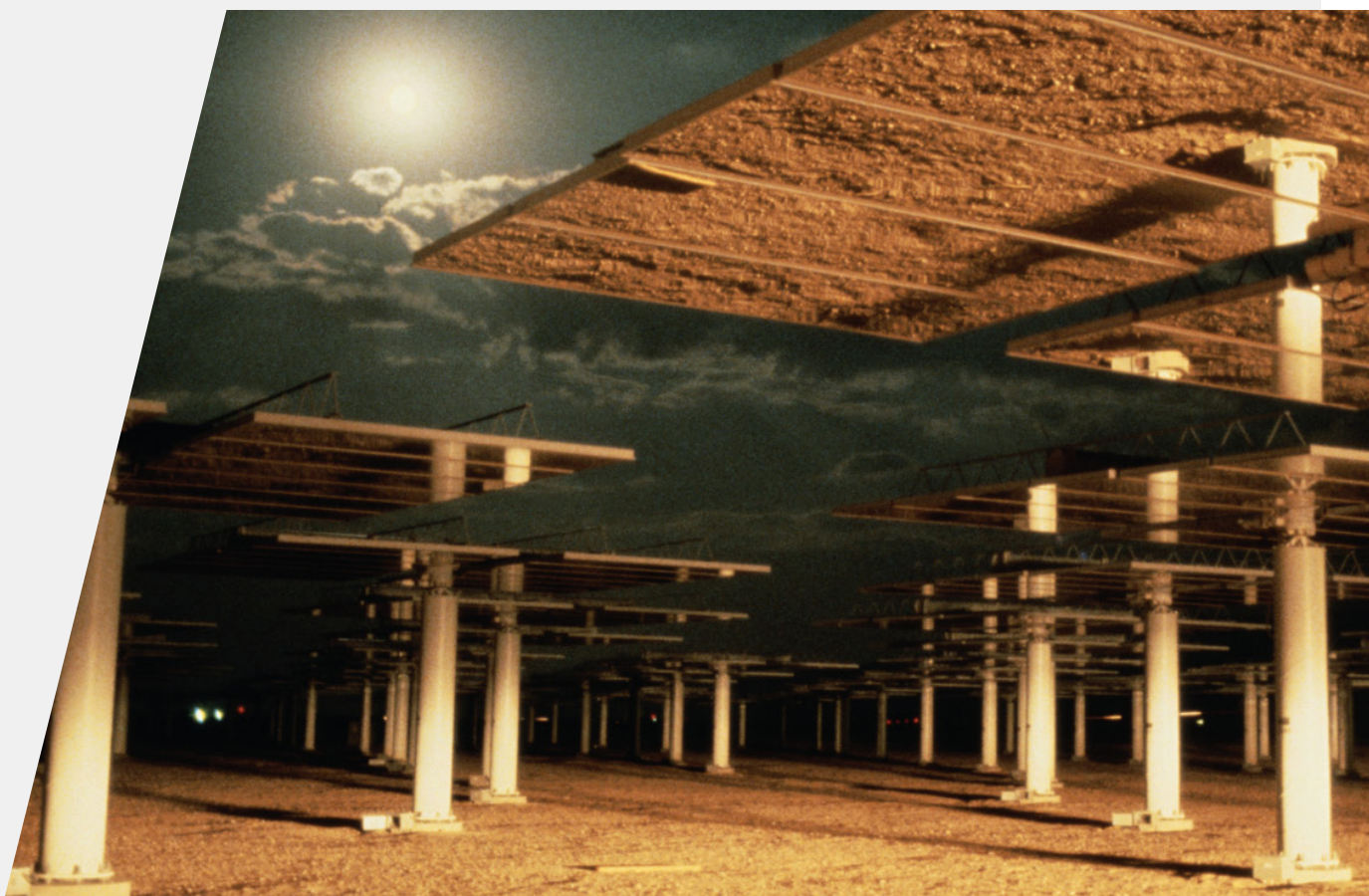
The government in November 2014 launched DDUGJY to ensure 24x7 power supply to all by 2019. The scheme with an allocation of INR430 billion would separate agriculture and non-agriculture feeder lines facilitating judicious rostering of supply to agricultural and non-agricultural consumers in rural areas, and would also strengthen and augment sub-transmission and distribution infrastructure in rural areas, including metering of distribution transformers/feeders/consumers. The scheme would require a budgetary support of INR334 billion over the entire implementation period.

Integrated power development scheme (IPDS)

IPDS was launched in Nov 2014 with the objective of reducing AT&C losses, establishing IT enabled energy accounting/auditing systems, improving billed energy based on metered consumption and improving collection efficiency. The estimated cost of the scheme is about INR326 billion and will require a budgetary support of INR253 billion over the entire implementation period. The scheme would involve strengthening of sub-transmission and distribution networks, metering of distribution transformers /feeders/consumers and IT enablement and strengthening of the distribution sector in the urban areas.

Thrust on renewables - Solar and wind energy targets

The Government has revised solar power capacity addition target from 20 GW by 2022 to 100GW by 2022. It is also targetting 60 GW of installed wind energy capacity by 2022 and is awaiting the cabinet's nod on the same.





Impact

From an Energy & Natural Resources (ENR) perspective, the budget focussed on a long term approach of institution building and evolving transparent frameworks, which is commendable. However, shorter term and critical pressing issues related to the revival of stressed assets or reigniting investor interest in the sector have not been addressed. Enhancement of fuel supply to power stations, creation of adequate transmission capacities, financial reform of discoms are some of the principal challenges which have not been resolved.

A role reversal between private and public sector in the shorter term is envisaged with higher emphasis on public sector investment in the near future. It would have been better if this increased public capital flow would have been channelised towards existing under utilised capacity leading to immediate benefits.

We would expect that the respective sector ministries would take major policy steps to address the immediate issues which is an imperative for sustainable growth of the sector.

Summary

- The power sector is expected to benefit from the creation of the National Investment in Infrastructure Fund and the Public Debt Management Authority which would lead to the development of a vibrant bond market and availability of equity and debt funds to the infrastructure sector
- Two new proposed legislations i.e. Public Contracts (Resolution of Disputes) Bill; and Regulatory Reform Bill would probably be a positive step to help resolve long standing power tariff disputes with high potential to aid the revival of projects impacted negatively. The step to bring out 'Bankruptcy Code' is a very positive measure to assist lenders resolve the sub-standard assets on their books
- The increase in clean energy cess on coal can provide meaningful support to renewable energy but mode of drawdown of these funds is still not clear even for funds already accumulated in the existing corpus
- The new five Ultra Mega Power Plants are likely to see limited investor interest as the industry is under financial stress and has very low appetite to invest in new capacity of such scale
- Details of achieving a renewable energy stretch target of a near 5X multiple from existing capacity were not provided. Achievement of this goal would require innovative means of financing and sourcing debt and equity, as also clarity on whether and how the already stressed distribution sector would be able to service this capacity through timely payment of tariffs
- Rationalisation of subsidies via the "Jan Dhan – Aadhar – Mobile telephony" trinity would augur well for oil PSUs and is a welcome step.

In nutshell, the budget holds out a promise of growth for the ENR sector, however, fails to address immediate concerns in the sector which is a void that would need an urgent redressal.

Unfinished agenda



What remains

- Much needed measures for revival of 45 GW of stranded and a significant additional under-utilised power generation capacity has not been addressed in the budget
- Result oriented implementation of schemes to address electricity distribution side challenges
- Policy & regulatory measures to implement 'obligation to serve' and 'renewable purchase obligations' critical for achieving 'power for all' and 'ambitious renewable targets'
- Finalisation of natural gas price pooling policy will immediately bring the stranded gas-based power capacity into operations
- Asset reconstruction companies to be created to take over non-performing assets of lenders and revitalise them. Power CPSEs can play the industrial investor role in such asset reconstruction
- Providing for construction of dedicated coal evacuation rail corridors has not been addressed
- A roadmap for greater PPPs in power transmission to address evacuation challenges required urgently
- Lack of clarity on availability of accelerated depreciation for the wind energy sector
- Several contentious issues in connection with deduction under section 80-IA remain unclarified
- Demand for Service tax exemption on the exploration activities and to the power sector and broad basing the existing customs duty exemption for E&P sector remained unfilled.

What is expected going forward

As Union budget 2015 addresses many key challenges of the sector, there are a few areas where further clarity and support from the government is required.

Utilisation of corpus of National Clean Energy Fund

With a further increase in the Clean Energy Cess, the corpus of this fund would enhance significantly. It is expected that this fund would be used to drive the large renewable energy target by various potential means, i.e. direct equity/ debt exposure to grid connected assets, seed capital for solar parks, supporting transmission corridors for renewable energy, creation of a sovereign hedge fund to attract private investments. Guidelines in this respect would be expected soon.

Transformation of Renewable Energy Financing Institution

Achievement of the goal of 175 GW renewable energy would require access to various innovative ways of financing debt as well as equity. It is expected that the government would use institutions like Indian Renewable Energy Development Agency (IREDA) to drive this transformation in financing. This would require significant capacity building of such institutions. The suggested transformation in financing is a 'game changer', to achieve this objective, a different approach to provide finance to this sector is necessary.

Deployment of National Investment in Infrastructure Fund

We expect that a very significant portion of the NIIF would be deployed towards creation of power sector infrastructure. It can provide a much needed source of capital for dedicated power sector financing institutions.

Private sector participation in commercial coal mining

The Coal Mines (Special Provisions) Ordinance made provision for enabling commercial mining. Operationalisation of the same is expected going forward. Private sector participation in coal mining can help in introduction of new and efficient technologies, enhancement of operational efficiency of the sector, and also increase domestic coal production.

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