High risk, low return

COAL INDIA LTD's shareholder value is threatened by poor corporate governance, faulty reserve estimations, regulatory risk and macro-economic issues.

Introduction

Coal India Limited is the world's largest coal miner, with a production of 435 million metric tons (MT) in 2011-2012. There is significant pressure on CIL to deliver annual production growth rates in excess of 7%. The company has a 2017 production target of 615 MT.[1]

Coal India's track record raises questions over its ability to deliver this rate of growth. In addition, serious governance issues are likely to impact CIL's financial performance. These pose a financial and reputational risk to CIL, its shareholders and lenders, while macro-economic issues in the Indian energy economy pose a long term threat to Coal India.

• CIL's attempts to access new mining areas are facing widespread opposition from local communities and environmental groups. With its reliance on open-pit mining, access to new mines are essential for CIL to achieve production targets.

• CIL has grown reliant on shallow, open pit mining for 90% of its production, and has lost in-house expertise on deep mining techniques.

• CIL has a record of poor corporate governance, manifested in rampant corruption, poor worker safety and repeated legal violations. This has, in the last year alone, led to penalties and closure notices for over 50 mines, threatening both its financial performance and reputation.

• CIL's financial performance has been affected by directives from majority shareholder Government of India to keep coal prices artifically low.[2] According to one estimate, this cost CIL $1.75 billion in the 2012-13 financial year alone.[3] The government has also taken away coal blocks allocated to CIL and given them to private players.[4]

• Changing economics of coal power in India; renewable energies are becoming cost-competitive even as coal faces increased regulatory scrutiny and public opposition.

• Questions have been raised over CIL's extractable reserves, with former CIL officials and government functionaries questioning the methodology used to compute CIL's coal reserves.

INVESTOR RISKS

- CIL's reliance on high biodiversity forest areas for expansion
- Public opposition on social and environmental grounds
- Financial liabilities from recurring legal violations, corruption & poor worker safety
- Mishandling of ESG issues pose a reputational risk to CIL and its investors
- CIL's coal reserves could be significantly exaggerated

INVESTOR BRIEFING

ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES
Risks To Coal India's Present And Future Profitability

I. CORRUPTION: CIL has a record of corruption at all levels, including senior management positions. Since October 2011 alone, the following violations have been reported:
October 2011: India's Central Bureau of Investigation (CBI) conducted simultaneous raids in 22 different places on officials of CIL subsidiary Northern Coalfields Limited. The officials were found to have shown "undue favour" to equipment suppliers. Cases have been registered against several officials, including then Chairman/Managing Director of NCL. According to the CBI, "a huge production loss due to malfunctioning of machines/ accessories and huge monetary loss due to purchase of machines equipments of higher costs were (sic) caused."[5]
February 2012: Officials from CIL subsidiary Central Coalfields Limited implicated in a $300,000 scam involving excessive payment to a private contractor.[6] In a separate case, a General Manager of Bharat Coking Coal Limited, another CIL subsidiary, was arrested on corruption charges.[7]
May 2012: The CBI investigated the "disappearance" of coal worth an estimated $36 million from Central Coalfields Limited, a CIL subsidiary.[8] The CBI reported that between 40% to 66% of coal from the three mines under investigation was missing.
July 2012: Illegal diversion of coal by officials of Western Coalfields Limited, a CIL subsidiary.[9]
In one subsidiary alone, Mahanadi Coalfields Limited, between 2005 and March 2012, 158 separate individuals were found guilty and penalized for corruption offences.[10]

II. LEGAL VIOLATIONS: Coal India Limited has a record of repeated violations of environmental legislation in India. This hampers productivity and raises the threat of stranded assets with several mines facing closure notices.
2005-ongoing: The Durgapur Rayatwari colliery, operated by Western Coalfields Limited (WCL), was ordered to cease operations in 2005 by the Bombay High Court. WCL appealed the order in 2005 and the case is currently being heard by the Supreme Court of India.
March 2010: India's Comptroller and Auditor General (CAG) stated that as of March 2010, 239 of Coal India's mines were operating illegally, without necessary environmental clearances.[11] Many of these mines proceeded to subsequently procure post-facto clearances, but several have faced the threat of closure.
August 2011: 22 mines operated by the same CIL subsidiary BCCL were served closure notices, also for operating without necessary forest clearances.[12]
May 2012: 43 CIL mines operated by CIL subsidiary Bharat Coking Coal Ltd. (BCCL) were served closure notices by the local state Pollution Control Board for operating without necessary forest clearances.[13]
May 2012: CIL subsidiary Mahanadi Coalfields Limited was fined ~ $237 million (Rs.13 billion) for illegal coal extraction in the Samaleswari coal mine. The same month, the company was ordered to close nine of its mines as operational licenses had expired and not been renewed.[14]
September 2012: Six mines operated by CIL subsidiary Mahanadi Coalfields Limited shut down for operating without necessary environmental clearances.[15] As of October 2012, the case is being heard by the courts.

III. POOR SAFETY RECORD: CIL's poor safety record opens the company to legal liabilities and compensation claims and has been the cause of labour unrest in the past. In 2011, CIL reported 52 fatalities in their mines and 250 serious injuries.[16] In 2010 alone, CIL operations resulted in an official death toll of 95, with another 183 serious injuries. From 2007 to 2009, there were 194 deaths arising from operational accidents and 904 serious injuries.[17]

IV. WATER AND AIR POLLUTION: Pollution resulting from coal mining operations is widespread in all of CIL's major operational areas. This has been documented most notably in the case of the Damodar river[18],[19] in the eastern state of Jharkhand which flows through the Karanpura coalfields where CIL subsidiary Central Coalfields Limited is active.[20]

High levels of pollution in most CIL mining areas pose a risk to the company's operations. In 2010, a moratorium on new coal projects was imposed in several coalfields due to critical pollution levels, forcing CIL to suspend expansion plans. The ban remains in place in four major coalfields as of November 2012.[21]

Apart from hindering production due to closures, CIL's environmental record also exposes the company to legal liabilities. Recent changes make it easier to claim compensation for environmental damage through the National Green Tribunal.[22] If these compensation claims are filed, they could further affect mine production.

V. CHILD LABOUR, FORCED DISPLACEMENT & POOR REHABILITATION: A report by the Haq Centre for Child Rights, New Delhi, has documented specific examples of child labour in the mines of Central Coalfields Limited, a CIL subsidiary.[23] From the Haq Centre's report, it is clear that the company is not exercising due diligence to curb the practice, creating legal liabilities.

INVESTOR RISKS

- CIL's record of repeated legal violations and poor worker safety is incompatible with investors' ESG commitments
- Worker safety, staff corruption and legal violations undermine CIL shareholder value

QUESTIONS FOR COAL INDIA

- How many mines currently face the threat of closure due to legal violations?
- What measures are being taken to ensure legal compliance of all CIL operations?
- What action has CIL taken to eliminate "unofficial" child labour in its operations?

ROADBLOCKS TO EXPANSION

I. FOREST DESTRUCTION AND COMMUNITY RESISTANCE: Coal India's operating model is overly reliant on open pit mines, which generate 90% of its production. Coal India has stated that it is looking at expansion into forest areas to meet its future production targets.[24] This is generating widespread opposition that threatens CIL's future expansion targets.

Open-pit mining entails clear-felling of forests, with impacts on forest-dependent communities, including Protected Tribal Groups, as well as endangered species such as the tiger and elephant. As a result, there is now growing opposition from tribal communities and environmental and human rights groups.

Opening new mines in forest areas is a lengthy process, with the high likelihood of legal challenges. Under Indian law, industrial operations in tiger habitat require an additional level of clearances from the National Tiger Conservation Authority. Mining in forest areas also requires the consent of tribal communities dependent on that particular forest area. In the recent past, clearances for coal blocks near a tiger reserve have been denied,[25] and other coal blocks and operative coal mines in other parts of the country are facing increased scrutiny and delays.[26],[27] A Greenpeace coordinated GIS analysis shows that many of CIL's ongoing and proposed coal mines are located in endangered species habitat and densely forested areas.[28] As of September 2012, 179 CIL mine proposals, covering 28,771 ha. of forest land, were awaiting forestry clearance from the Ministry of Environment & Forests, Government of India.[29]

II. NEW REGULATORY RISK: New proposals currently being discussed by the Indian Government to declare important forest areas off limits to coal mining will further limit CIL's access to new mines.[30] A broad coalition of social justice and environmental groups have petitioned the Indian government asking for a public process to determine forest areas that will be closed to coal mining, based on biodiversity and livelihood values, among other factors. This process is being discussed by the Indian Ministry of Environment & Forests.[31]

III. INEFFICIENT AND OUTDATED MINING PRACTICES: CIL has attributed its inability to raise production in recent years to delays in receiving environmental clearances for new mines.[32] This, however, has been disputed by the Ministry of Environment & Forests, which claims that Coal India Limited has already been granted mining permission on 55,000 ha. of forest land, and 200,000 ha. in total,[33] despite which it has been either unable or unwilling to raise productivity. Independent analyses show that the rate of clearances for coal mining in India from 2007-2011 was in fact at an all time high.[34] CIL's inability to raise production levels from areas it already has access to indicates poor operational management and inadequate strategic oversight -- a warning sign for investors, given that fresh attempts to expand are more likely to face community opposition.

CIL is overly reliant on open-pit mines for its production, and has lost in-house expertise in deep mining. As mentioned above, permissions for open-pit mines are increasingly hard to come by, whereas permit requirements for underground mines are easier to satisfy, as the land requirement is significantly less. In an article in the Chicago Tribune, the Director of the Indian School of Mines has warned that CIL's output from open-cast mines will stagnate by the end of this decade, urging a shift in focus to underground mines.[35]

If the company is able to increase its share of production from underground mines, thereby reducing the need for forestry clearances, it might be better placed to increase production. However, given the significantly higher production costs involved, will CIL be able to do this and maintain profitability?

INVESTOR RISKS

- CIL's destruction of forest areas and displacement of tribal communities is incompatible with investors' environmental commitments
- CIL will not be able to meet its ambitious production targets due to expansion roadblocks.
- By inefficiently utliising its existing land bank, CIL is undermining shareholder value

QUESTIONS FOR COAL INDIA

- What steps are being taken to reduce dependence on mining operations in forest areas, endangered species habitat and areas important to the livelihoods of forest-dependent and tribal communities?
- What steps are being taken to reduce dependence on open-pit mining?
- Why are additional forest areas being sought when permitted production levels have not been reached from CIL's existing land bank?
- How does CIL plan to win over local communities affected by its mines, and address environmental concerns?
- What investments are being made to increase productivity of underground mines?

BREACH OF FIDUCIARY RESPONSIBILITY

Minority shareholder TCI (UK) has accused the Coal India management of breaching their fiduciary responsibility, in respect of its coal pricing policies and the signing of Fuel Supply Agreements with customers on disadvantageous terms. TCI has initiated legal action against both the Government of India (as majority shareholder) and the Board of Coal India Ltd. on these grounds, in separate cases.

In its letter dated March 12, 2012[37] to the Board of CIL, TCI makes the following points:

1. That on January 31, 2012, the Board of CIL reversed a coal price increase on the basis of a directive from the Ministry of Coal, Government of India on December 31, 2011. This is even though coal pricing is officially deregulated. As a result, CIL's coal prices remain up to 70% below that of landed imported coal, despite a demand supply mismatch. TCI estimates that in the current financial year alone this has cost the company $1.75 billion, and $43 billion since the IPO in 2010.[38]

2. That the Prime Minister's Office has also directed CIL to sign Fuel Supply Agreements with independent power producers guaranteeing 80% of the contracted quantity, failing which CIL would be penalized. This amount of subsidized coal is far in excess of what CIL's board is ready to supply and again threatens the revenues of the company by forcing it to sell most of its coal at a subsidized price, and threatening it with financial penalties.

A separate report by financial analysts Equitorials, commissioned by Greenpeace, has estimated CIL's likely financial penalties resulting from the FSAs at nearly US $300 million over the next five years.[36]

INVESTOR RISKS

- Majority shareholder Government of India is suppressing coal prices, reducing CIL's profitability

QUESTIONS FOR COAL INDIA

- What steps does it intend to take to ensure optimal price recovery of its coal production?
- What impact will the potential financial penalties imposed for under-supply have on profitability over the next decade?

FALLING PRICE OF ALTERNATIVE ENERGY

With plunging solar costs and maturing wind technology, electricity from new coal-fired thermal plants is losing its historical cost advantage. This is especially true for plants running on imported coal, but is also increasingly applicable for new coal plants designed to run on Indian coal. Wind power is at or below grid parity in several locations in India,[39] and solar PV is expected to reach grid parity by 2017.[40] At the same time, coal's expansion is facing growing headwinds in the form of increased public scrutiny, difficulty acquiring land and growing environmental and health concerns.

Given the high volumes of investment flowing into India's renewable energy sector, ($10.3 billion in 2011 according to Bloomberg New Energy Finance[41]) combined with the gradual rise in tariffs for coal-fired power, it is feasible that coal's share of Indian energy supply will begin to decline over the next decade. Leading Indian coal-fired generator TATA Power has publicly expressed its opinion that future growth will be in renewables rather than coal due to a combination of land and rising costs in the coal sector, and falling costs for renewables.[42] Tata Power Sustainability Advisor Tim Flannery recently opined that India is set to "leapfrog into renewables".[43]

INVESTOR RISKS

- Rapid uptake in renewables could combine with the existing headwinds in the coal sector to limit CIL's expansion.

CIL's COAL RESERVE RISKS

Questions have been raised as to CIL's actual coal resource, which the company put at 64.79 billion tonnes in its Red Herring Prospectus, with 21.8 BT of this considered extractable. However, several researchers, including former CIL officials and government functionaries have opined that economically extractable reserves could be significantly less, and have questioned the procedure used to compute coal reserves as CIL has not used the internationally accepted United Nations Framework Classification (UNFC) to compute its reserves, relying instead on the Indian Standard Procedure (ISP).

The Energy Research Institute, in a March 2011 Policy brief says: *"The coal that can be extracted—taking into account geological, technical, and economic aspects - is only a small fraction of our total coal inventories", warning that India might not even have sufficient extractable coal for the next 40 years, as is currently believed.* [44]

INVESTOR RISKS

- CIL's stated resource of 64 billion tonnes could be significantly overstated
- CIL's reserves of economically extractable coal could be significantly less than stated

QUESTIONS FOR COAL INDIA

- What steps is it taking to ensure that it follows the UNFC system to compute its reserves?
- By when will data on CIL's coal reserves computed by the UNFC system be available?
- How much of CIL's reserves are economically extractable?

CONCLUSION

Coal India's record of legal violations and internal corruption expose it to significant financial liabilities. Coal India's operating model poses a significant risk to the environment, to local communities and by extension to investors. The company's expansion plans face resistance from local communities, environmental groups and the falling price of renewable power in India. Coal India's reserves could be significantly overstated and its outdated mining practices are preventing full exploitation of coal in existing mines.

Investors should consider whether CIL's reliance on highly destructive open-pit mining in forest areas threatens the long-term financial viability of the company and whether its neglect of Environmental, Social and Governance issues exposes the company to financial and reputational risks.

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