Lessons from the Coal Blocks Auction*

C.P. Chandrasekhar

The first round of the auction of mining rights in 18 coal blocks to user firms in the private sector in the power, steel and cement industries has been completed. If the figures being circulated of the revenues or benefits that would accrue to different sections as a result are true, the process has been remarkably successful. According to estimates for 17 of the 18 blocks, over a 30-year period the coal producing states would receive a sum of Rs. 1,08,010 crore as proceeds from the e-auction and from royalties due. In addition, as per an estimate that is less robust, consumers in states receiving power from the plants to which the 7 coal blocks reserved for the power sector are attached, are projected to benefit to the extent of Rs. 37,050 crore a year because of lower tariffs. This is only the first tranche of auctions, with a second already in process. If the numbers are right, when the process is complete the gains to beneficiaries is likely to be huge.

The current auction was forced on the government by a Supreme Court judgement delivered in September last year to cancel all but four of 218 coal block allocations made between 1993 and 2010, on the grounds that they were arbitrary and illegal. Since 24 of these allocations had been withdrawn for various reasons during this period, there are 194 blocks that had remained effectively allocated.

The Supreme Court's judgement in essence upheld the findings of a 2012 performance audit by the Comptroller and Auditor General (CAG) on the Allocation of Coal Blocks and Augmentation of Coal Production. The audit noted that while an inter-ministerial Screening Committee decided on the allocation of coal blocks to end-users in the private sector, the "minutes of the Steering Committee did not indicate how each one of the applicants for a particular coal block was evaluated," rendering the process non-transparent. This mattered because the cost of production of coal from the captive mines would be much less than the price of equivalent grade coal supplied by Coal India Limited (CIL). Since the prices of end-products are administratively or otherwise linked to the "official" price of coal as charged by CIL, producers of such products with access to captive coal blocks would be making windfall gains. This not only deprived the government of revenues, but also amounted to a profit transfer to an arbitrarily chosen set of producers.

It was not that the government of the day did not recognise the anomaly involved. In fact, as far back as 2004, the Ministry of Coal had declared the need to shift to a system of competitive bidding to decide on the allocation of captive coal blocks to private players. A note on "Competitive Bidding for allocation of coal blocks" prepared by the Coal Secretary in July 2004 made a case for the shift, arguing that "…the bidding system will only tap part of the windfall profit for the public purpose… ." However, for a variety of reasons, including delays in ensuring legislative amendments needed for the shift, two successive UPA governments continued with the arbitrary and commercially unsound system of allocation. The CAG report estimated that the loss to the exchequer on account of this was as much as RS.1.86 lakh crore. The results of the first of the auctions, covering 18 out of 194 blocks, suggest that this estimate is possibly not just plausible, but an underestimate.

A unique feature of the auction process was the different methods adopted for bidders from the power sector, where the prices are regulated through power purchase agreements or price fixing authorities, and other user industries. In the case of captive blocks for the power sector the method adopted was a reverse auction, with the price of equivalent grade coal charged by CIL serving as the ceiling price. If no coal block auction had been held, CIL's price would define the coal cost taken into account when pricing electricity, irrespective of the actual cost of extracting coal from the captive coal block that supports electricity production. Under the reverse auction scheme the bidder quotes a price equal to or below the CIL benchmark, which would be taken into consideration when pricing electricity produced with coal extracted from the block being auctioned. Besides this, the bidder must offer to pay the government of the state in which the block is located a price quoted per tonne for the coal extracted. The reserve or minimum price to be paid to the state government was set at Rs. 100 per tonne. What is surprising is that in the case of many blocks, bidders have agreed to set the fuel cost in the power tariff calculation at zero. That amounts to absorbing the costs of extraction by reducing the margins they receive. In addition, these bidders have, in an associated forward bid for the sum per tonne they are willing to pay the state government, agreed to pay the concerned government much more than the Rs.100-per-tonne reserve price.

As opposed to this procedure adopted for power, in the case of user industries other than power (such as, steel and cement) the price of coal was set by a process of regular forward bidding, with a reserve price linked to CIL's prices. The bid determines the cost of coal for the user plant consisting of the extraction cost, royalties, bid price and freight charges for transportation from coal mine. Here too the bidders have been aggressive offering prices much higher than those that were expected. But in many cases this seems to be justified by the fact that the bid price is lower than the cost of imported coal, which they had been partly relying on.

The real issue then is, what is to be made of the outcome of this auction? The outcome does question the rationale behind the government's decision not to exploit these mines and allocate it instead to the private sector on the grounds that it is not in a position to undertake the investments needed to extract the coal. That failure was presented as explaining the growing import dependence as the demand for coal rose, resulting in the outflow of foreign exchange on account of coal despite the availability of domestic reserves. What emerges now is that coal extraction is an extremely lucrative activity. The government could have stuck to expanding public sector coal production and garnered the resulting profits, without handing it over to the private sector.

Moreover, even if coal blocks were to be handed over to private players in user industries as a captive facility with restrictions on use, this should not only have been done through a transparent process, but one that priced the resources so that the resulting revenues could be used by governments for other developmental purposes. Allocating coal blocks to selected private parties without a transparent pricing system, and without regulating the pricing of the end-products to ensure that the lower fuel cost benefit is shared between the producers involved and consumers, amounted to an arbitrary transfer from the government to selected private players is reflective of a kind of crony capitalism. The aggressive bidding that has characterised this round of bidding points to the huge gains that those favoured with an allocation would or could have made.

The auction experience also seems to suggest that the argument that the UPA's block allocation policy helped rein in power prices is completely misplaced, since producers seem willing to set fuel costs at zero to calculate power tariffs, as well as pay state governments a price for the coal extracted that was much higher than the reserve price set by the auctioneer. As a result, despite power producers paying huge sums to the government, power tariffs are expected to come down rather than rise.

The shock generated by the aggressive bidding has led to the view that the outcome was partly the result of excessive competition and a degree of irrational exuberance that would disappear in later rounds, and also reflective of the inclination of firms to ensure secure supplies of the raw material, even if that resulted in much lower profits. The basis for that reasoning is weak, and it seems to be a way of concealing the fact that private sector operators who were allocated captive coal blocks had made huge windfall gains. Some of them did not get those gains since they had not begun to work the block before the allocations were cancelled.

In sum, along with the spectrum scam, the coal scam is proof of the fact that, far from increasing transparency in economic policy matters, "economic reform" by privileging measures that incentivise private participation in economic activity leads to arbitrary decision making. The only defence that those who supported the direct as opposed to bidding-based allocation policy had was that it was a way of accelerating domestic production of coal with the help of the private sector. That too does not tally with the evidence, since many of those arbitrarily chosen as candidates for allocation, chose to sit on rather than exploit their extraction rights. They must have presumed that the benefits in terms of windfall gains could be cashed in due time, since these were long term lease arrangements.

Further, given the presence and volume of the windfall gains that could be made, it is difficult to believe that all of those involved in arbitrarily directing those gains to one private player or the other did not receive any of those gains. The possibility of graft therefore needs to be investigated. And if found, it would only strengthen the view that "economic reform" not only encourage arbitrariness in decision making, but also promoted corruption.

The BJP-led NDA is not only crowing about the success of its auction, but is using that success as a justification for the coal ordinance it has issued and is now seeking to push through Parliament. Clearly, no such ordinance was needed to launch the competitive bidding process, and the NDA would possibly not have resorted to such bidding for already allotted blocks had the Supreme Court not forced it to. The real need for the ordinance is to take liberalisation of the coal sector further and allow individual private players mining rights not just for captive extraction to support their own end-use capacities, but for sale in the open market. The ordinance is a mandate to privatise or denationalise the coal sector, and therefore would only worsen the loss that the exchequer and the people would suffer at the expense of private profits.

*** This article was originally published in the Frontline, Print edition: March 20, 2015.**