



Energy and Natural Resources

Union Budget 2016

Post-Budget sectoral point of view



#Budget2016 | #KPMGIndiaBudget

<http://www.kpmg.com/IN/budget2016>

Table of contents

1. Context
2. Key policies/fiscal and tax proposals
3. Unfinished agenda



Context



Where we are

With renewable energy increasingly taking the centre stage, India's energy sector is in the middle of a tectonic shift. The country is committed to increasing its renewable energy capacity to 40 per cent of installed power generation capacity by year 2030.¹

The government is walking the talk on its renewable energy promise and during the last year a near 10 GW of solar auctions have been conducted between central and state governments.² Grid parity is also in sight with private sector lapping up the auctions with tariffs dropping to record lows of INR4.34/KWh in recent bids.³ Roof-top solar and off-grid applications are another silent revolution in the making. Maturing of storage technologies has a potential to radically alter the present way energy is generated and delivered in future.

Capacity addition of 17.2 GW in the year coupled with slow industrial demand growth, brought the peak electricity deficit down to 1.8 per cent.⁴ We are nearing the realisation of a seamless national grid. The Ujwal DISCOM Assurance Yojna (UDAY), signed by many key states,⁵ is a step in the right direction to help revive the long ailing distribution sector.⁵

On the brighter side, Production of domestic coal continued to gain momentum. Between April to December 2015, the, output of Coal India Limited increased by 9 per cent to reach 373.45 MT, thus enhancing the availability of coal to end users.⁶

On one hand where the energy sector made substantial progress last year, particularly in power, on the other hand, progress made by oil and gas was tepid. While the domestic gas production continued to dwindle, present low natural gas prices kept investor interest restricted in any fresh exploration. The government introduced Power System Development Fund (PSDF) which is aimed at providing much needed succor to the gas power stations; nearly 18.2 billion units⁷ of electricity were pumped into the grid by this subsidy mechanism.

The phrase, "you can't be living always in the promise of the clouds, it must rain now," reflects the situation of stressed assets particularly in coal fired power plants owned by the private sector. Slow pace of regulatory action, non-happening of bids at desired pace, lack of fuel for plants whose coal blocks were cancelled and lack of liquidity for such plants are key reasons to the Non Performing Assets (NPA) situation for lenders.

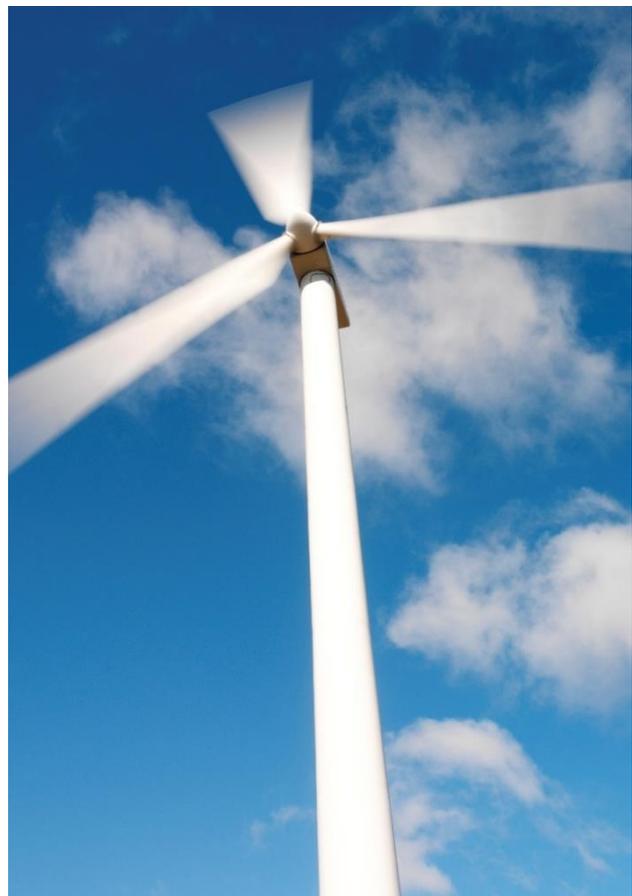
1. http://www.business-standard.com/article/economy-policy/india-s-energy-mix-to-have-40-renewable-sources-by-2030-115092200057_1.html Business Standard accessed on 29th Feb 2016
2. <http://www.mnre.gov.in/>, KPMG in India analysis
3. http://www.business-standard.com/article/news-cm/solar-tariff-at-a-new-low-of-rs-4-34-per-unit-116011901301_1.html Business Standard accessed on 29th Feb 2016
4. <http://www.mnre.gov.in/>, and CEA Executive Summary Jan 2016
5. <http://pib.nic.in/newsite/PrintRelease.aspx?relid=136636> accessed on 29 Feb 2015
6. http://www.business-standard.com/article/companies/coal-india-s-production-and-offtake-rises-by-over-9-during-april-december-116010200324_1.html accessed on 29 Feb 2016
7. <http://pib.nic.in/newsite/mainpage.aspx> accessed on 29 February 2016



Expectations (policy/fiscal/tax)



- A stressed asset revival fund empowered to perform capital as well as operational restructuring of stressed power plants assets was the need of the hour and such a vehicle was expected to be launched under the National Investment and Infrastructure Fund (NIIF) or as a special venture by banks
- Hydro power with its undisputable long-term benefits needs support to lower the upfront tariffs. To support new hydro installations, a viability gap funding mechanism was expected to be proposed/set-up
- The government was expected to allocate a pilot fund to support emerging technologies, such as renewable energy, that requires smart grids and storage facilities to enable large scale integration
- Along with greater reforms for opening up coal for commercial mining, the government was expected to lay down a roadmap to free coal pricing and ease end use restrictions
- Low gas prices have virtually stalled fresh exploration activity. The government was expected to review the gas pricing formula and benchmark it to key Liquefied Natural Gas (LNG) hubs to support a higher price and thus encourage fresh exploration activity
- Introduction of tax parity between wind and solar power in terms of excise duty, customs duty and CENVAT credit
- Service tax in respect of various input services procured by power industry should be made zero rated; and refund of input services used for providing such services should be made available to the service provider
- Inclusion of third parties appointed by a private party (distribution licensee) under the definition of 'electricity transmission or distribution utility' in negative list of services
- Inclusion of natural gas as 'declared goods' to help reduce the applicable VAT rate to 5 per cent or less.
- Reduce custom duty on imported LNG to 2.5 per cent or less
- Inclusion of goods required for transportation of natural gas in the category of goods eligible for concessional Central Sales Tax (CST) against Form C, under central Sales Tax Act, 1956.
- Considering high volatility in crude oil prices, Oil Industries Development (OID) cess collected as excise duty is expected to be levied at ad-valorem basis. Further, CENVAT credit of the same anticipated to be made available to off-set against the output liability.
- Exemption from payment of Minimum Alternative Tax (MAT) where tax holiday is being claimed under Section 80-IA/IB of the Income tax Act (the Act)
- Non applicability of Section 14A of the Act for holding companies investing in Special Purpose Vehicle (SPVs) for power projects
- Extension of benefits under Section 42 of the Act to (i) Pre-New Exploration Licensing Policy (NELP) contracts which have the President's assent; and (ii) for expenses incurred in connection with oil and gas blocks situated outside India
- Clarity on the taxability of income of a 'foreign service provider' engaged in exploration activities under the presumptive tax regime vis-à-vis taxability as a 'fees for technical services' was expected.



Key policies/fiscal and tax proposals



Key announcements¹

- The 'Clean Energy' cess levied on coal, lignite, and peat is proposed to be renamed as 'Clean Environment' cess and, simultaneously, increase its rate from INR200 per tonne to INR400 per tonne.
- To incentivise gas production from deep-water, ultra deep-water and high pressure-high temperature areas, which are currently not exploited on account of higher costs and higher risks, the government proposes to introduce a calibrated market freedom for new discoveries and areas yet to commence production. This is proposed to be done at a pre-determined ceiling price to be discovered on the principle of landed price of alternative fuels.
- A comprehensive plan spanning fifteen to twenty years, is proposed to augment investment in nuclear power generation and made a budgetary allocation of INR30 billion per annum in addition to other public sector investments.
- Proposal to permit mobilisation of additional finance to the extent of INR313 billion by various public sector financing institutions, the ones from energy sector being Power Finance Corporation (PFC), Rural Electrification Corporation (REC), and Indian Renewable Energy Development Agency (IREDA), was also made.
- To reinvigorate the private sector investment in Public Private Partnership (PPPs), following three initiatives were announced:
 - Public Utility (Resolution of Disputes) Bill to be introduced in FY2016-17 to streamline institutional arrangements for resolution of disputes in infrastructure related construction contracts, PPPs and public utility contracts
 - Guidelines for renegotiation of PPP concession agreements to be issued to address potential uncertainties of real economy without compromising transparency
 - A new credit rating system for infrastructure projects which gives emphasis to inbuilt credit enhancement mechanisms will be developed.
- The Central Public Sector Enterprises (CPSEs) can now raise fresh capital for investments by monetisation of various assets, i.e. land, manufacturing units etc.
- The Budget proposed a scheme to provide LPG connections to 15 million BPL households and made a budgetary allocation of INR20 billion for the same.

Direct tax proposals

- The rate of accelerated depreciation on renewable energy assets reduced from 80 per cent to 40 per cent with effect from FY2017-18. The proposed rate is applicable to all the assets, whether old or new, falling under the relevant block of assets
- Benefit of additional depreciation at the rate of 20 per cent on cost of new plant and machinery extended to businesses engaged in the transmission or distribution of power with effect from 1 April 2017
- Dividend distributed by the Special Purpose Vehicle (SPV) from its current income to Infrastructure Investment Trust (InvIT) will not be subject to dividend distribution tax with effect from 1 June 2016 where:
 - the InvIT either holds 100 per cent of the share capital of the SPV or holds all the share capital other than that which is required to be held by any entity as a part of any direction of any government or specific requirement under law; and
 - the dividend is distributed out of the current income after the date when the InvIT acquires the shareholding referred in the SPV.
- The dividend, referred above, received by the InvIT and its investor shall not be taxable in the hands of the trust or investors with effect from 1 June 2016
- In case of companies set-up and registered on or after 1 March 2016 and engaged in the business of manufacturing or production of any article or thing, the tax payer has an option to be taxed at the rate of 25 per cent (without availing any prescribed deduction/set-off/depreciation) or at the existing rate of 30 per cent (after availing prescribed deduction/set-off/depreciation)
- Deduction at the rate of 15 per cent of the actual cost of new assets under section 32AC (1A) of the Income-tax Act, 1961 is available to the tax payers where cost of such new assets acquired in any previous year exceeds INR250 million and such assets are installed on or before 31 March 2017; It has been clarified that where year of acquisition and installation of the new assets is different, the deduction shall be allowed in the year of installation
- No tax holiday under section 80-IB(9) of the Income-tax Act, 1961 would be available to an undertaking engaged in production of mineral oil or natural gas, if the commercial production commences on or after 1 April 2017

1. Union Budget 2016-17, <http://indiabudget.nic.in/glance.asp>, 29 February 2016

- Income accruing or arising to a foreign company on account of storage of crude oil in a facility in India and sale of crude oil therefrom to any person resident in India is proposed to be exempt from tax, provided such income is pursuant to an arrangement or agreement entered into with or approved and notified by the central government
- Weighted deduction for expenditure on scientific research on approved in-house research and development facility restricted to 150 per cent from AY2018-19 to AY 2020-21 and to 100 per cent from AY 2021-22 onwards;
- Deduction under section 80JJAA is now available to all tax payers liable to tax audit under section 44AB of the Income-tax Act, 1961. Deduction under section 80JJAA is equal to 30 per cent of additional employee cost incurred in the previous year. The minimum number of days for which they should be employed during the year is proposed to be reduced from 300 to 240 days. No deduction will however be admissible in respect of employees whose monthly emoluments exceed INR25,000.
- Explanation has been inserted to clarify where the gas sold/purchased and transported through a common carrier pipeline or any other common transport distribution systems becomes co-mingled and fungible with other gas in the pipeline or system and such gas is introduced into the pipeline or system in one state and is taken out from the pipeline in another state, such sale or purchase of gas shall be deemed to be a movement of goods from one state to another (with effect from date of assent to Finance Bill, 2016)
- Excise duty on certain goods used to manufacture of rotor blades for wind operated electricity generators increased from nil to 6 per cent (with effect from 1 March 2016)
- Excise duty on solar lamps reduced from 12.5 per cent to nil (with effect from 1 March 2016)
- Scope of exemption from excise duty available for initial setting up of power generation project using non-conventional materials has been widened to cover projects where agreement for processing municipal solid waste is entered with urban local body for at least ten years (with effect from 1 March 2016)
- OID cess has been reduced from INR4,500 PMT to 20 per cent ad valorem (ad valorem date of assent to Finance Bill, 2016)

Indirect tax proposals

- The Basic Custom Duty (BCD) increased from 7.5 per cent to 10 per cent for specified goods of Chapter 84, 85 and 90 of custom tariff, e.g. boiler, hydraulic turbines, industrial solar water heater and electric motors and generators
- BCD on coal gas, water gas, producer gas and similar gases, other than petroleum gases and other gaseous hydrocarbons, tar distilled from coal, from lignite or from peat and other mineral tars, whether or not dehydrated or partially distilled, including reconstituted tars, pitch and pitch coke, obtained from coal tar or from other mineral tars, coke and semi-coke of coal, of lignite or of peat, whether or not agglomerated, retort carbon reduced to 5 per cent (with effect from 1 March 2016)
- Exemption from BCD on solar tempered glass/solar tempered (anti-reflective coated) glass for use in manufacture of solar cells/panels/modules withdrawn and 5 per cent BCD levied (with effect from 1 March 2016)
- Exemption extended on specified goods imported by ONGC or OIL in connection with petroleum operations undertaken under Petroleum Exploration Licenses (PEL) or Mining Leases (ML) issued or renewed before 1 April 1999 (with effect from 1 March 2016)
- CENVAT credit of service tax paid on amount charged for assignment by government or any other person of a natural resource such as mines etc. shall be spread over the period of time for which the rights have been assigned (with effect from 1 April 2016)

Recent policy updates

National tariff policy²

In January 2016, Government of India (GoI) approved the proposed amendments in the Power Tariff Policy. The approved amendments focus on achieving 4Es, i.e., electricity, environment, efficiency and ease of doing business and complement the UDAY in achieving its objectives. These amendments can facilitate competition, improve efficiency in operations, help improve quality of electricity supply, help ensure availability of electricity at competitive and reasonable rates, promote clean energy development, and attract investments in the power sector.

UDAY³

Launched in December 2015, UDAY is an optional scheme for all states and aims to improve the financial health of the Distribution Companies (DISCOMs) and provides a permanent resolution to the key issues faced by the DISCOMs through four initiatives:

- Improving operational efficiency of DISCOMs by using smart meters, Light Emitting Diode (LED) bulbs, upgraded transmission infrastructure, etc.
- Reducing cost of power by increased use of domestic coal, coal linkage rationalisation, coal price rationalisation, coal swaps from inefficient plants to efficient ones, etc.
- Reducing interest cost of DISCOMs: Under the scheme, respective state governments are expected to take over 75 per cent of DISCOMs' debt (50 per cent in FY2015-16 and 25 per cent in FY2016-17). This could reduce the debt burden and, in addition, the interest cost of DISCOMs from around 14 to 15 per cent to about 8 to 9 per cent.
- Enforcing financial discipline on DISCOMs through alignment with state finances.

Additionally, under this scheme, states can avail additional/priority funding from Ministry of Power (MoP) and Ministry of New and Renewable Energy (MNRE) schemes such as 'Deendayal Upadhyaya Gram Jyoti Yojana' (DDUGJY), Integrated Power Development Scheme (IPDS), PSDF, etc. However, states that do not meet the operational milestones are liable to lose their grants from DDUGJY and IPDS.

Marginal Field Policy (MFP)⁴

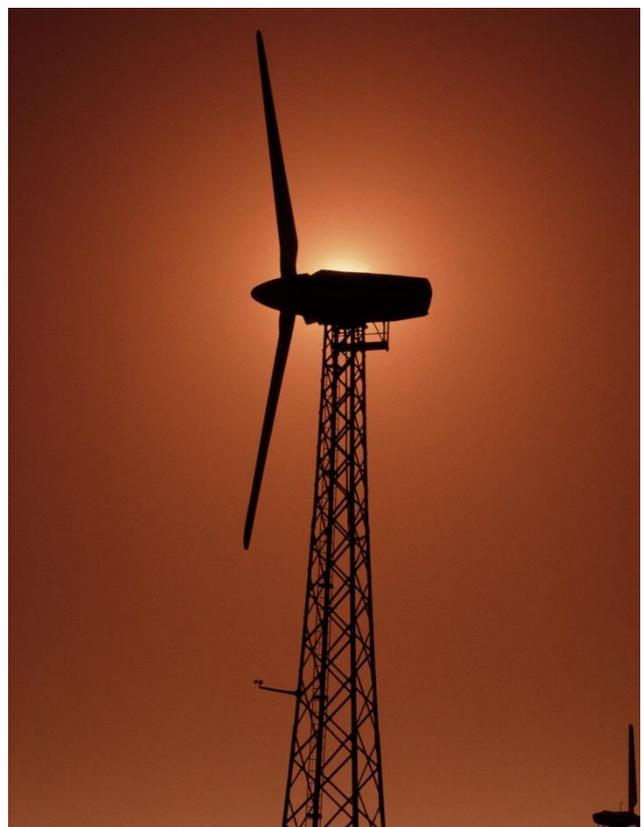
This policy aims at operationalising 69 marginal oil and gas fields that could not be monetised due to high development and production cost. The MFP allows sale of oil and gas produced from these fields at market determined prices. It also allows exploration of conventional and non-conventional hydrocarbon under a single license system.

Underground Coal Gasification (UCG)⁵

In December 2015, GoI approved development of coal and lignite fields using UCG technology. Under this policy, coal and lignite blocks will be auctioned on a revenue sharing basis via a competitive bidding process. The Central Mine Planning and Design Institute (CMPDI) has been designated as the nodal agency for allocating the coal and lignite blocks.

Automatic transfer of Coal Linkage/Letter of Assurance (LoA)⁶

GoI has recently approved automatic transfer of LoA/Coal Linkage of an old plant to a new plant with supercritical technology. This policy is applicable to only those pre-New Coal Distribution Policy (NCDP) plants that are owned by PSUs and that have long-term linkages or LoA.



2. http://pmindia.gov.in/en/news_updates/cabinet-approves-amendments-in-power-tariff-policy-to-ensure-24x7-affordable-power-for-all/ accessed on 29 Feb 2016
 3. <http://pib.nic.in/newsite/PrintRelease.aspx?relid=130261> accessed on 29 Feb 2016
 4. <http://pib.nic.in/newsite/PrintRelease.aspx?relid=128772> accessed on 29 Feb 2016
 5. <http://pib.nic.in/newsite/PrintRelease.aspx?relid=133405> accessed on 29 Feb 2016
 6. http://coal.nic.in/sites/upload_files/coal/files/curentnotices/18022016.pdf accessed on 29 Feb 2016



Our point of view

The Union Budget 2016 attempts to cement the paradigm shift towards renewable energy while at the same time acknowledges the need to diversify the fuel basket. It refrained from big bang measures and focussed on consolidation to achieve 'energy security' for the country. Intent to have a 'comprehensive generation plan' over next fifteen to twenty years for nuclear power brings this important resource to mainstream focus apart from renewables, which is a positive move as it would address India's 'fascination with single fuel' and bring a holistic view required to achieve energy security.

As much as the market participants would have liked to see a head-on resolution of stressed assets, the Budget proposed a gradual and incremental approach which may not be very pragmatic given that a few of these assets are right at the precipice. Expectation was to have a 'specialised turnaround stressed fund'. Though Budget reiterated the intent to resolve commercial disputes, and talked of having guidelines for 're-negotiation of PPPs', and enhanced power of institutions under the SARFEASI Act, these may not lead to faster resolution of stressed asset problem in short-term.

- The Budget focussed on the lowest denominator who have still not seen access to quality infrastructure: The government set an early target of 1 May 2018 for electrification of all villages in the country. It further committed to issue 15 million LPG connections to BPL households.
- A timeline for introduction of dispute resolution/re-negotiation frameworks is positive. The industry expects that these measures shall provide amicable frameworks to resolve long-standing power tariff disputes without protracted legal battles.
- Doubling of 'Clean Environment' cess' is expected to have an upward impact on tariffs by INR0.12 - 0.16/KWh. Given the power tariff competitiveness desirable for 'Make in India' this upward push on costs of base load coal power is negative. Though the incremental realisations can help provide impetus to the ambitious clean energy vision of the government.
- The calibrated market pricing mechanism for gas fields is a real positive, however it applies to new discoveries or fields yet to commence production. Given the liberalised nature of markets, an open market mechanism applicable for all gas fields could have been more desirable. The existing participants would have also got additional liquidity to invest in new discoveries or enhancing production from current blocks.
- Another interesting resource generation measure for making new investments pertains to divestment of assets by Central Public Sector Enterprises (CPSEs). If implemented well, this can lead to significant generation of resources outside the normal equity divestment window.
- Little dampener for the renewable sector as accelerated depreciation benefits gets restricted to 40 per cent from 1 April 2017. However, this is in line with the overall direction outlined by Finance Minister (FM) in respect of reduction in corporate tax rates while doing away with various tax exemptions.

The Budget has committed to large scale uplift of rural income, improvement of rural infrastructure (RURBAN clusters), improving ease of doing business, incentivising setting up of new manufacturing units. These measures, though not directed at the energy sector, are likely to create a large 'pull-through demand' for energy and may lead to overall improvement in the sector's economic position over medium to long term.

Unfinished agenda

What remains



- A direct stressed asset resolution mechanism via either a stressed asset revival fund type vehicle or a focussed asset reconstruction vehicle is required to bring back a large stranded capacity into the grid
- Hydro power which is economical in long run but has high upfront costs would need enhanced support. A viability gap funding mechanism or an alternate support mechanism was expected
- The coal mine auctions for power sector have not gained much traction after the first two rounds. The government was expected to reconsider the auction mechanics to attract greater private sector interest going forward.
- Several contentious issues in connection with deduction under section 80-IA of the Act remains unclarified
- Demand for service tax exemption on the exploration activities and to the power sector and broad basing the existing customs duty exemption for Explorations and Production (E&P) sector remained unfilled.

What is expected going forward



- Large scale deployment of renewable energy would generate challenges of grid integration. DISCOMs with their stressed financials do not have the wherewithal to address it. A federal level centre of excellence with adequate financial support may be mooted to deploy new technologies like smart grids, demand side management measures
- As commercial mining is likely to be introduced in coal sector, it is expected that frameworks for an open market sale of coal would be implemented. This would entail doing away of the LoA/Coal Linkage mechanism and creating a large open pool of contracted/spot markets
- A 'directional integrated energy policy' which envisages a fuel mix for long-term is essential. This policy should inter-alia detail future base load power demand and thus consequent coal to be available so that investors can take long-term positions. Appropriate power generation sources to meet peaking power demand should also be planned.





KPMG in India contacts:

Nitin Atroley

Partner and Head
Sales and Markets
T: +91 124 307 4887
E: nitinatroley@kpmg.com

Arvind Mahajan

Partner and Head
Infrastructure and Government Services
T: +91 22 3090 1740
E: arvindmahajan@kpmg.com

Manish Aggarwal

Partner and Head
Energy and Natural Resources
T: +91 22 3090 2625
E: manishaggarwal@kpmg.com

Follow us on:

kpmg.com/in/socialmedia



Download the KPMG in India apps:



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

This is meant for e-communication only.