



chairman's statement

The year 2010-11 was notable in IDFC's growth and development for several reasons. This has been a year where our performance on financial metrics has been more than satisfactory despite overall sluggishness in infrastructure sector growth. More importantly, IDFC put into effect a key element of our longer term strategy of diversifying our resource-raising.

In July 2010, IDFC got the Infrastructure Finance Company (IFC) status within the NBFC category from the Reserve Bank of India (RBI). We leveraged this status to raise debt capital through the issue of infrastructure bonds. As a measure of our efforts to widen our reach among ordinary households, we raised ₹ 1,451 crore from over 7.3 lakh retail investors. In addition, the IFC status, by allowing us to raise capital through External Commercial Borrowing (ECB), has also opened access to a new class of international debt finance agencies. Going forward, we would use our new relationship with these foreign financial institutions to leverage capital in forms other than ECBs, including rupee bonds.

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Complementing our core activities in financing infrastructure development in the country, we have carved out our development agenda under the rubric of the IDFC

Foundation. The Foundation has now been registered as a company under Section 25 of the Companies Act, 1956, which deals with not-for-profit companies. IDFC will support the Foundation through a certain percentage of its profits every year. The Foundation will also be able to raise more third-party non-commercial development funds for activities such as training government employees and advising the government in policy matters, one of the prime objectives behind the setting up of IDFC. Moreover, I am happy to inform you that IDFC actively continues to contribute to the policy formulation and development strategies of several sectors. IDFC has been nominated on several committees set up by the Union Government including in the transport sector, on electricity distribution, urban water and sanitation, and several financial sector reform committees.

Notwithstanding a good financial year, there are serious challenges mounting in the infrastructure sector. Lack of effective governance and policy/regulatory uncertainty is perhaps the biggest challenge facing not just the infrastructure sectors, but the country at large. Corruption issues that came to the fore in the past year have had a serious negative

fall-out. Besides eroding investor confidence, the working environment has become more difficult due to extreme risk aversion in decision-making and consequent delays.

In the power sector, the impact of poor governance by states, lack of political will for reforms, and stalled regulatory processes is leading to a critical situation. This is clearly a matter of concern since this is a priority sector accounting for nearly one-third of the projected investments in infrastructure during the Eleventh Five Year Plan. The private sector's role has been growing in power generation capacity, as evidenced by the increase in its share in capacity addition from 13% in the Tenth Five Year Plan to 30% in the first four years of the Eleventh Five Year Plan. While an additional 40,000 MW is expected to be commissioned in the next four years, effectively doubling existing private sector installed generation capacity, there could well be a slowing down of this new capacity coming on-stream. Essentially, this is due to two key risks that the sector is facing – fuel risk and off-taker risk. As a result, many thermal plants are operating below capacity and the commissioning of some new ones is being delayed.

On the fuel risk, shortfalls in domestic coal supply have emerged as a major speed-breaker to electricity production. Despite having the fourth largest coal reserves in the world, our power sector cannot get the coal it needs. Coal India's production has been unable to keep pace with the increase in domestic coal-based power capacity. A firm commitment for the supply of domestic coal in the form of a Fuel Supply Agreement is difficult for power developers to obtain and the agreement is skewed in favour of the fuel supplier, leaving the developer with great uncertainty and limited recourse. Given the recent increased pace of power generation capacity addition and the substantial project pipeline, the coal demand-supply gap is only likely to worsen. To meet the incremental coal demand from the power sector alone, we estimate that domestic coal production has to increase annually by 11% as against a historical average growth rate of 6%. Failure to keep up with rising demand will increase our dependence on imported coal to achieve desired capacity utilisation levels (plant load factors) which, in turn, would imply an increase in the cost of generation and vulnerability to

global fluctuations in coal prices and freight charges. I must add here that the reliance on imported coal to improve capacity utilisation of existing domestic coal-based power plants is, of course, limited by the technology already locked into, as well as the available infrastructure capacity, mainly ports and road and rail connectivity. It is therefore urgent to solve the fuel problem so as not to have stranded assets.

The expected increase in the cost of power generation brings to the fore another key challenge facing the power sector – the stalling of tariff reforms. Tariff revisions have not kept pace with the rising fuel prices. Some State governments, on their part, have been reluctant to levy even nominal user charges for large consumer categories such as agriculture, while resisting attempts to rationalise electricity tariffs for other categories such as domestic consumers. The total amount due to State governments' decision to subsidise such consumer categories more than doubled in 3 years from ₹ 12,233 crore in 2005-06 to ₹ 29,665 crore in 2008-09, and has increased even further over the two subsequent years. This clearly has an impact on the fiscal position of State governments. In fact, because of the constrained fiscal situation, the subsidy payments by State governments have not matched their commitments, with consequent cash losses having to be incurred by the discoms (distribution companies). All three factors – delays in tariff revisions, increasing subsidy burden, and shortfalls in subsidy payments from State governments – have contributed to the poor financial health of the discoms as characterised by their increasing cash losses, which have risen to an estimated ₹ 70,000 crore or 0.9% of GDP in 2010-11, up from 0.4% of GDP in 2004-05. This is despite several discoms bringing about operational improvements and reducing their Aggregate Technical & Commercial (AT&C) losses. As a result, some discoms have resorted to load-shedding rather than purchasing power. This has led to the investor community arguing strongly in favour of urgent corrective action to deal with such off-taker risks. After all, it reflects a serious crisis of governance that consumers have to face blackouts when power generators have surplus power that is not purchased because the State-owned discoms are bleeding financially. It is thus critical that



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effective regulatory action keep pace with the changing market and economic conditions to ensure the long-term viability of the sector.

These challenges in the power sector underscore the need to escalate our efforts in harnessing renewable energy sources and reducing our dependence on increasingly expensive fossil fuel based power generation. An increased share of clean and renewable energy sources in the nation's energy portfolio would have a double dividend – mitigating a critical constraint to our continued growth and development, as well as lowering greenhouse gas emissions (GHG) and local pollution. Electricity sources such as wind and solar energy, which do not have the fuel supply risks associated with coal-based power plants, also benefit from a favourable regulatory and policy regime. Here initiatives such as feed-in tariffs for renewable energy and capital subsidies for

construction of the renewable power plants go a long way in mitigating the risks associated with thermal power plants. As electricity generation constitutes the bulk of our GHG inventory (38%), even the co-benefits from such a strategy are significant. The recently released Kirit Parikh Committee Report on Low Carbon Strategies for Inclusive Growth estimates that nearly 145 million tonnes of CO₂, over 9% of the baseline emissions in 2020, could be reduced in electricity supply with aggressive efforts to increase the share of clean coal, nuclear, wind and solar energy in our electricity generation mix.

Besides the larger governance issues afflicting the infrastructure sector, project execution risks have grown, especially difficulties in land acquisition, and unaddressed environmental and social impacts. Environmental and social impacts of

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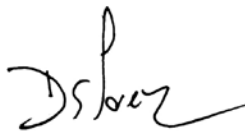
power, mining and other major infrastructure projects continue to be significant. Several large projects have been held up for both these reasons, including some of the proposed Ultra Mega Power Plants (UMPPs). Delays in land acquisition, environmental clearances, and declaration of several resource-rich but ecologically sensitive areas as 'No-go areas' have also contributed to the tardiness in developing coal mines.

The strict application of the 'Go – No Go Area' policy by the Ministry of Environment and Forests points to how critical the environmental challenge is. Much of the untapped resources lie in areas that are more sensitive, both ecologically and socially. It is crucial that a clear, sustainable development policy emerge to address this apparent deadlock between environmental conservation and social inclusion on one hand and infrastructure development on the other. Further, the processes of environmental clearances need to allow for greater engagement with local civil society right from the inception and planning stages to ensure some ownership and effective participation of local populations. Moreover, schemes and projects need to be designed whereby local populations also share in the benefits from infrastructure development. Unless the execution risks associated with environmental and land acquisition issues are resolved urgently, it will be difficult to sustain even the current pace of infrastructure development.

While the challenges at hand are clearly significant and require urgent action, there is no doubt that the targeted GDP growth of 9-9.5% envisaged in the Twelfth Five Year Plan would depend crucially on increased investments in the infrastructure sectors. This is also recognised in the issues for approach to the Twelfth Plan, which argues for a reprioritisation in the allocation of resources

in favour of social and economic infrastructure sectors, and a greater role for public private partnerships in infrastructure development alongwith urgent attention to policy and institutional bottlenecks. Thus, the medium to long-term outlook does present significant growth opportunities. IDFC, being a key player in bringing together private financing of infrastructure projects, would continue to play an important role.

My colleagues at IDFC recognise that we have to enhance and expand our efforts in the coming years and meet the high performance expectations that the nation has come to expect from IDFC. Here I would like to thank my colleagues for the efforts put in this year.



DEEPAK S. PAREKH
Chairman