

# STRANDED OUT WEST: THE IMMINENT FAILURE OF LANCO INFRATECH'S INVESTMENT IN GRIFFIN COAL

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Griffin Mine, photo by Andy Graham

*"It is difficult to get a man to understand something, when his salary depends on his not understanding it."*- Upton Sinclair, Author and Journalist



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## Executive Summary

The acquisition of Griffin Coal by Lanco Infratech at the peak of the coal boom is at serious risk of becoming a stranded investment with potential negative impacts on investors, Western Australian taxpayers and the local community of Collie.

Analysis by IEEFA of Lanco Infratech's financial position indicates that Lanco Infratech's local subsidiary, Lanco Resources Australia Pty Ltd. faces a likelihood of insolvency in early 2015.

Requests for public subsidies to prop up the business are unlikely to have a material impact on the underlying financials of the business and should be resisted by policymakers.

The imminent failure of Lanco Infratech's Griffin Coal business points to an increasingly urgent need for Federal and State Government planning to prepare for the economic and social impacts of the structural decline of coal.

## Background & context

Three Indian power and infrastructure conglomerates (Adani, GVK and Lanco Infratech) all invested in Australian coal mining projects in 2011, which has proved with hindsight to have been the peak of the global coal boom. All three Indian firms were already financially leveraged and yet used almost entirely debt financing for their Australian acquisitions. All three paid very full prices at the top of the coal cycle. Since that time the world energy markets have undergone a substantial transition due to technology and policy changes. The seaborne coal price has fallen more than 50% and listed coal company share prices in the main have fallen by 60-90% in the last four years. Each of the three project proposals each have a questionable level of commercial viability, have faced a series of delays and are calling for taxpayer subsidies.

Each of these Indian coal projects are likely to be impacted significantly by the energy policy initiatives now being developed in India by Prime Minister Narendra Modi and Energy Minister Piyush Goyal as they seek to fix India's flawed electricity system. A key aspect of these new plans is to significantly reduce India's need for unaffordable imported thermal coal. Minister Goyal surprised the global coal industry in November 2014 by announcing that: "Possibly in the next two or three years we should be able to stop imports of thermal coal."<sup>1</sup>

This major government policy development significantly undermines the original strategic rationale for the three Australian thermal coal export proposals by Lanco Infratech, GVK and Adani.

## A stranded investment?

Much public attention has focused on the two Indian proposals in the Galilee Basin in Queensland by the GVK and Adani groups. This report focuses on a third, that being

Lanco Infratech's A\$750m acquisition of Griffin Coal in Collie, West Australia. Our analysis shows this acquisition runs the real risk of being another *stranded asset*.

When Lanco Infratech acquired the Griffin Coal mine in February 2011, it was in poor operating and financial shape, having been run by an administrator since the global financial crisis. Lanco Infratech's A\$1bn expansion plan for Griffin Coal was optimistic, particularly in the face of what appears to be a structural decline in the global seaborne thermal coal market.

Griffin Coal continues to operate at below gross cashflow breakeven, such that it is struggling to pay for equipment maintenance<sup>ii</sup> and the interest let alone have scope to repay the capital on \$600-800m of debts outstanding against the local Australian entity. In the absence of an equity injection from Lanco Infratech, administration looks like a distinct probability if the global thermal coal market remains depressed. Trading while insolvent is an issue that Directors and officers of the company should be monitoring closely. A likely catalyst for restructuring is the pending A\$150m final deferred payment due February 2015.

A number of factors mitigate against any sale of Griffin Coal:

1. The depressed state of the global seaborne thermal coal markets, with potentially a permanent, structural decline in demand;
2. The lack of large scale existing coal export facilities close to the Collie operations;
3. The lower than benchmark energy content of the Collie Basin coal;
4. The loss-making state of the business for much of the last five years;
5. The long term fixed price nature of the domestic coal supply contracts in Western Australia;
6. Existing debts secured against the Australian coal business (possibly as much as US\$663m);
7. A \$20m+ unfunded mine rehabilitation charge outstanding; and
8. A \$150m final payment due February 2015 to the creditors of the last insolvent business structure that owned Griffin Coal.

IEEFA would be surprised if there were many potential buyers of the Griffin Coal business. A return to voluntary administration is a possible eventuality given we would estimate that with a negative EBITDA and significant net debt, the Australian subsidiaries have a negative equity value approaching the sum of the debt and the rehabilitation liabilities combined.

## Recommendations

This report raises three wider public policy questions that are evident from an analysis of Griffin Coal:

1. **Taxpayer funded subsidies to coal:** IEEFA examines the recent A\$240m coal mine subsidy granted by the Western Australian government to Griffin Coal's key competitor, Yancoal Australia in October 2014. We note the November 2014

announcements by the Queensland State Premier of similar taxpayer funded subsidy proposals being offered to Adani Mining for their Galilee Basin venture, including the many hundreds of millions of dollars of equity funding for the proposed railroad, and the generous provision of water infrastructure, dredge spoil removal and / or a coal royalty holiday. Given coal is a mature industry that argues for a level playing field, we question the rationale for taxpayer subsidies. **IEEFA recommends that Western Australian policy makers reject any request to provide additional subsidies to support Griffin Coal.**

2. **The need for a community transition plan:** The evident structural decline of the coal industry highlights the need for long term national and state level energy plans, and an associated plan to support local communities transition towards industries of the future. Failure to predict and plan for the transition will only lead to worse economic and social outcomes and the failure to develop alternative economic opportunities. IEEFA recommends that Australian Federal and State Governments begin developing transition plans for coal dependent communities in light of the structural decline of coal markets globally.
3. **The need for stronger enforcement of mine rehabilitation bonds:** IEEFA notes the absence of any material environmental remediation bond protection at Griffin Coal. West Australian taxpayers could well end up with yet another significant unfunded mine remediation liability of well over \$20m. IEEFA Recommends:
  - a. stronger independent review and enforcement of the new mine rehabilitation laws in Western Australia, and a review of the State Agreement Act and other regulatory arrangements for the Collie Coal mines, to bring them in line with contemporary regulatory environment for mining;
  - b. Remediation bonds should equal the likely commercial costs (rather than relying on Directors' valuations);
  - c. Remediation bonds should be fully funded at the start of any project as it is generally too late if this issue is delayed until the mine hits financial difficulties once operating.

## Section 1: Lanco Infratech Overview

### Background on Lanco Infratech

Lanco Infratech was one of India's largest power and infrastructure companies, expanding aggressively using primarily debt financing over the last five years. This expansion program came to a halt post 2013 when Lanco Infratech entered corporate debt restructuring discussions with its Indian bankers. Lanco Infratech had operations spanning: solar project construction and ownership; property development; thermal and hydro based power plant construction and ownership; road infrastructure; and most recently coal mining in India and Australia (the later via its acquisition Griffin Coal in 2011).

The major shareholders ("Promoters" in Indian parlance) of Lanco Infratech own 70.7% of the issued equity of the company.

Revenue peaked in 2011/12 at US\$3.1bn, while net profits peaked in 2010/11 at US\$189m. Lanco Infratech subsequently saw profitability collapse to a loss of US\$214m in 2012/13<sup>iii</sup> and further to a loss of US\$458m in 2013/14 on a 35% collapse in group revenues.

Total assets quadrupled from US\$1.6bn as at March 2010 to US\$7.7bn by March 2013. However, Lanco Infratech reports that net debt likewise trebled to US\$5.7bn by September 2014 (using current exchange rates of Rs61.8/USD), that being 20 times the written down net book value of equity in the company.<sup>iv</sup> This expansion was predicated on Indian real gross domestic product growth continuing at the 8% pa seen through to 2011/12 and the assumption the company could manage a multitude of complex greenfield project developments across a multitude of diverse sectors concurrently. India's increased reliance on expensive imported thermal coal was presumed to continue.

### Projects Stalled

Lanco Infratech was one of many Indian power and infrastructure companies who had committed to multiple greenfield project developments only to find regulatory and land acquisitions were difficult to complete on time. As just one example, Lanco was reported to have failed to get Environment Ministry approval for the final 2% of the land it needs to build a Rs69bn (US\$1.1 billion) power plant in the eastern state of Odisha, impeding progress for a project that has been stalled for five years.<sup>v</sup>

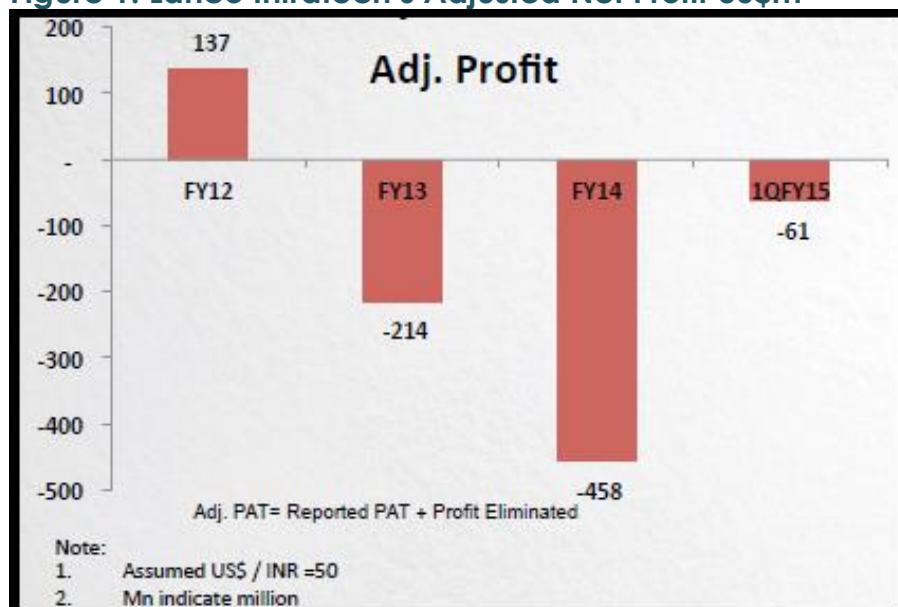
### Limited Coal Mining Experience

Lanco Infratech was indirectly allocated the Gare pelma II coal mining block in the state of Chhattisgarh in India a number of years back, but in late 2014 the Supreme Court cancelled Lanco Infratech's rights to this project. As such, Lanco has little experience in building or operating coal mines in India.

## Section 2: Lanco Infratech – Profit & Loss

Lanco Infratech's revenue peaked in 2011/12 at US\$3.1bn, while net profits peaked in 2010/11 at US\$189m. Lanco Infratech subsequently saw profitability collapse to a loss of US\$214m in 2012/13 and further to a loss of US\$458m in 2013/14 on a 35% collapse in group revenues – Figure 1.

**Figure 1: Lanco Infratech's Adjusted Net Profit US\$m**



Source: Lanco Infratech Corporate Presentation, August 2014

Key constraints have been:

1. an inability to access acceptably priced fuel for use in Lanco Infratech's thermal power plants;
2. project development cost blowouts and land acquisition delays;
3. a ballooning of interest expense as a reflection of the quadrupling of net indebtedness of the group and a significant rise in Indian corporate interest rates from 8.0-8.5% to 12.5-13.5% pa in the last three years;<sup>vi</sup>
4. the inability to collect revenues from the State owned electricity distribution companies (due to their financial distress); and
5. Lanco Infratech heavy financial leverage has increasingly impacted its ability to fund and enter into new external engineering, procurement and construction commitments.

Lanco Infratech's employee numbers peaked at just under 8,000 in 2012 and has more than halved to 3,575 by September 2014. Asset sales post the September 2014 quarter end will have reduced that further.

Lanco reported a net loss for the six months to September 2014 of Rs8.3bn (US\$134m), albeit a 27% reduction in the loss incurred in the prior corresponding period. Finance and foreign exchange costs of Rs16.5bn (US\$267m) were more than Lanco Infratech's earnings before interest, tax and depreciation of Rs13.0bn.

## Section 3: Lanco Infratech – State of the Balance Sheet

Lanco Infratech has seen a trebling of net debt over the last four years to US\$5.7bn as at the last reported figures of September 2014 – Figure 2. Lanco Infratech reports net book value of equity including minority interests is US\$286m as at September 2014, such that net gearing (net debt to equity) is reaching 20 times book value of net equity.

**Figure 2: Lanco Infratech Net Debt (US\$bn)**

Lanco Infratech (Consolidated)	March 2013	March 2014	Sept 2014
Long term borrowings	4.2	4.9	
Current maturities of long term borrowings	0.4	0.3	
Short term borrowings	0.9	0.8	
<b>Gross Debt (US\$ Billion)</b>	<b>5.5</b>	<b>5.9</b>	<b>5.8</b>
<i>Less:</i>			
Cash	-0.1	-0.1	-0.1
<b>Net Debt (US\$ Billion)</b>	<b>5.4</b>	<b>5.8</b>	<b>5.7</b>

Source: Lanco Infratech 2013/14 Annual Report & 1HF2014/15 result; all figures converted at Rs61.8/US\$

### Lanco Infratech's consolidated net debt

The full year result announcement from Lanco Infratech for 2013/14 released on 23 May 2014 has a cryptic note to the consolidated net debt table on page 2 that states gross debt "Excludes acquisition debt in Griffin Coal and working capital loans to power companies." This statement seems inconsistent with the subsequently released annual report, but implies Lanco Infratech is not consolidating the debts of its Australian coal mining subsidiaries.

### Corporate debt restructuring

Lanco Infratech's Rs 7,500-crore corporate debt restructuring (CDR) proposal was negotiated over the second half of 2013 and agreed to in December 2013. This agreement relates to only the parent company of the Lanco Infratech group and includes a two year moratorium on interest payments for some fund-based facilities.<sup>vii</sup> The CDR is the coordinating arm of the lenders for Indian companies in corporate distress. Lanco Infratech has 25 Indian banks involved in its CDR, which is one of the largest in Indian history. As part of the plan, Lanco Infratech has agreed to exit from various stakes in projects and subsidiary companies.

As part of the plan, Lanco Infratech's promoters are expected to bring in fresh funds of about US\$80m,<sup>viii</sup> with US\$25m of unsecured loans provided to the company by promoters before year end 2013/14.<sup>ix</sup>

Lanco Infratech's main lenders include IDIB Bank, State Bank of India, United Bank of India and ICICI Bank Ltd.



## Section 4: Lanco Infratech – Divesting Power Assets

Early in 2014 Lanco Infratech sold 80 MW of hydro electricity facilities and is in the process of completing the sale of its 1,200 MW Udupi thermal power plant. The combined proceeds of US\$1.3bn help reduce Lanco Infratech's net debt by some 20% to US\$4.5bn. However, given Lanco Infratech continues to report net losses (US\$134m in the last reported half to September 2014), with a number of Lanco Infratech power facilities idle due to fuel supply issues and disputes over the power purchase agreements, the financial position remains unsustainable and reliant on a strong recovery in the Indian economy over 2015.

### Sale of the 70MW Budhil Hydro Power Project February 2014

In February 2014 Lanco Infratech sold its 70MW Budhil Hydro Power Project and two smaller 5MW hydro facilities in Himachal Pradesh to Greenko Energies for Rs 655 crore (US\$100m).<sup>x</sup>

### Sale of the 1,200MW Udupi Imported Coal-Fired Power Plant November 2014

In September 2014 Lanco Infratech announced it would sell its loss-making 1,200-MW imported coal-fired power plant at Udupi in Karnataka for more than Rs 6,000 crore (US\$1.2bn) to Adani Power. The transaction was approved in November 2014.<sup>xixii</sup>



Adit tunnel, part of an unfinished Lanco Hydropower project. Teesta River – Sikkim, India

## Section 5: Acquisition of Griffin Coal in 2011

### History of Griffin Coal

Griffin Coal is based at the Collie Basin, in the south west of Western Australia. The Company's origins can be traced back to 1923, when a private syndicate was formed to develop coal leases to the south of Collie to supply coal to Western Australian Government Railways. Griffin Coal was awarded a share in the supply of coal to a major Western Australian power station in 1960.



Griffin Coal is one of two large coal suppliers in Western Australia, producing 3-4Mtpa of coal, making it one of the largest employers in Collie. Griffin Coal supplies State government owned coal-fired power plants in south west Western Australia. Griffin has a coal resource of 1.1 billion tonnes, but the commercial viability of these resources is debatable.

Under the private ownership of Ric Stowe, Griffin Coal moved to vertically integrate by constructing the 458MW Bluewaters coal-fired power station situated near the mine in Collie. The Bluewaters power station was commissioned in 2009 and operates within the South West Integrated System. Bluewaters was funded by \$1.1 billion of senior and mezzanine project debt provided by a syndicate of 15 local and foreign banks, with ANZ Banking Group a lead lender.

Following the global financial crisis, an adverse Australian Tax Office settlement and excessive gearing, the Griffin Energy Group entered voluntary administration in January 2010.<sup>xiii</sup>

Griffin Coal had reported a net loss of A\$124m in 2010/11 (after a net loss of \$46m in 2009/10).

### A Peak of Cycle Acquisition of an Insolvent Domestic Coal Mine

In February 2011 Griffin Coal Mining Company P/L was purchased by Lanco Infratech, through its Australian subsidiary Lanco Resources Australia Pty Ltd. Lanco Infratech paid A\$750m to KordaMetha who had been appointed Voluntary Administrator to the insolvent Griffin Energy Group P/L in January 2010.<sup>xiv</sup> Lanco Infratech's acquisition pricing settlement was reported to be split:

1. A\$500m cash immediately;
2. A\$100m paid in February 2013; and
3. A\$150m due by February 2015.

## Lawsuit from Perdaman Chemicals

In the second half of 2013 Lanco Infratech settled a long-pending \$3.5-billion (Rs 20,300-crore) lawsuit relating to Griffin Coal with Perdaman Chemicals for a reported A\$7.5m plus legal costs.<sup>xv</sup>

## Debt Secured against Griffin Coal

The Lanco Infratech 2013/14 annual report details that the Griffin Coal Mining Company P/L is a 100% owned subsidiary of Lanco Resources Australia P/L, which in turn is a 100% owned subsidiary of Lanco Resource International P/L (Singapore) which in turn is 100% owned by Lanco Infratech Limited, the Indian listed parent company. Lanco Resource International P/L (Singapore) is reported to have debts of US\$457m as at March 2014, while Lanco Resources Australia P/L has debts of US\$205m. Assuming these are separate loans, this would equate to total debt of US\$663m.<sup>xvi</sup>

## Section 6: Griffin Coal – Profit & Loss

Griffin Coal's loss before interest, tax, depreciation and amortisation (EBITDA) almost doubled in the fiscal year through March 2013 to Rs1.03 billion, and losses more than doubled again in the year to March 2014 to a loss of Rs3.82 billion.

At the exchange rate on 31 March 2014, this translates to a 2013/14 A\$69m EBITDA loss – Figure 3.

**Figure 3: Lanco Resources Profit & Loss (A\$m)**

Year ended 31st March		2012	2013	2014	Change yoy
Revenue	(A\$m)	124.5	172.2	122.9	-29%
EBITDA	(A\$m)	-7.9	-18.6	-69.0	
Depreciation	(A\$m)	-32.1	-35.7	-31.3	-12%
Segmental EBIT	(A\$m)	-40.1	-54.3	-100.3	
Capex	(A\$m)	132.1	75.9	43.8	-42%

Source: Lanco Infratech Annual Reports 2012/13 and 2013/14, all figures converted at Rs55.4/A\$

## One-off Payment from Bluewaters Booked in 4QFY2012/13

Overall Lanco Infratech received a onetime payment of A\$46m in 4QFY2012/13 in relation to a settlement with Bluewaters Power Station (previously named Griffin Power) for coal deliveries in that and previous years. This distorts the revenue reported and percent changes in relation to the 2012/13 year. Bluewaters was owned by an associated company of Griffin Coal during and prior to the period of receivership.

## Production Has Consistently Missed Targets

At Griffin Coal, the production for the 2012/13 year was 3.11Mt (with sales of 3.03Mt), of which 0.75Mt is allowed to be exported through the port of Kwinana. Lanco Infratech reported plans to boost output to 5Mtpa in 2013/14 and then 18Mtpa by fiscal 2018.<sup>xvii</sup><sup>xviii</sup> In November 2012 Griffin Coal submitted plans to the WA EPA for production to be increased by up to fivefold to 20Mtpa with a mine life exceeding 50 years.<sup>xix</sup>

In contrast to the exceptionally positive guidance of 25% volume growth for 2013/14, production at Griffin Coal during 2013-14 declined 9% year-on-year to 2.83Mt (with sales of 2.95Mt). Lanco Infratech again reported in August 2014 a production target of 5Mtpa for 2014/15.<sup>xx</sup>

We calculate the value received for Griffin Coal at A\$41.67/tonne of coal in 2013/14. Falling production and absence of the one off Bluewaters' payment contributed to a 29% decline in revenue to A\$122.9m in 2013/14 – Figure 4.

In February 2014 Griffin Coal Chief Financial Officer James Riordan said the company was now targeting September 2014 to begin exports, with plans to export 1.2Mt in the first year on the way to exports of 16Mtpa by 2018.<sup>xxi</sup> However, at the same time as company management was forecasting strong volume growth, questions were being raised about Griffin Coal's ability to even supply its domestic commitments - refer below.

**Figure 4: Lanco Resources Coal Production and Value (A\$ per tonne)**

Year ended 31st March		2012	2013	2014	Change yoy
Coal Production	(Mt)	3.16	3.11	2.83	-9%
Coal Sales	(Mt)	3.16	3.03	2.95	-3%
Coal Value	(A\$/t)	39.41	56.83	41.67	-27%
Cash cost of production	(A\$/t)	41.92	62.96	65.05	3%
Revenue	(A\$m)	124.5	172.2	122.9	-29%

Source: Lanco Infratech Annual Reports 2012/13 and 2013/14, all figures converted at Rs55.4/A\$

## A Debt Funded Acquisition of Griffin Coal

Lanco Infratech put in place total debt facilities of US\$800m in 2011 at the time of acquisition of Griffin Coal. A US\$550m initial loan with a funding cost of 410 basis points over LIBOR stepped up to 525 basis points over LIBOR earlier in 2014, as well as US\$5m establishment fee. ICICI Bank of India was reported at the time to have held the vast majority of this debt due to an inability to syndicate the loan. A further US\$250m standby line of credit was also arranged. This facility suggests Griffin Coal is carrying at least a US\$20m annual interest bill.

In April 2014 the press reported that Credit Suisse was trying to arrange syndication of a new replacement debt facility of US\$450m.<sup>xxii</sup> IEEFA has no seen any update on this proposal.

## Cashflow Problems Accelerate over 2013/14

Griffin Coal has seen considerable adverse press in the last 18 months, much of which speculates about increasingly difficulties in cashflow management given heightened operating losses, expanding debts and mounting interest expenses both at the Australian subsidiaries and the Indian group level:

- In June 2013 ASIC records show that the court action by Perdaman Chemicals regarding a notice of court action relating to winding-up Griffin Coal was dismissed.
- on 29 June 2013 the Australian Tax Office commenced proceedings in the Federal court to get Griffin Coal put into administration for failure to pay A\$13.9m of outstanding tax.<sup>xxiii</sup> ASIC records show this was dismissed in August 2013, implying the debt was cleared.
- In August 2013 it was reported that Griffin Coal had not paid A\$1.5m of employee superannuation.<sup>xxiv</sup>
- In March 2014 Griffin Coal was reported as late paying its coal lease rentals to the government.<sup>xxv</sup>
- In June 2014<sup>xxvi</sup>, again in July 2014<sup>xxvii</sup>, in September 2014<sup>xxviii</sup> and again in November 2014,<sup>xxix</sup> it was reported that Griffin Coal had delayed payments to Carna Civil Mining, the company contracted to provide the 300 strong work-force that operates the Griffin Coal mine.
- In August 2014 it was reported that the Bureau of Meteorology had moved to wind up Griffin Coal over an outstanding \$45,000 debt.<sup>xxx</sup>
- In November 2014 the press reported another work stoppage over payment delays.<sup>xxxi</sup>

## September 2014 Half Result – Griffin Coal

Griffin Coal reported an A\$24.5m earnings before interest, tax, depreciation and amortisation (EBITDA) for the six months to September 2014, a significant reduction on the A\$37m loss booked in the previous corresponding period. The average coal price realised was A\$44/t, up 2% year-on-year.

However against these positive figures, Griffin Coal's six month production was reported at 1.34Mt, down 9% year-on-year, with coal sales of 1.34Mt down 17% year-on-year. Given the relatively high fixed cost nature of coal mining, this dramatic decline in sales volumes has left cash cost of production at an excessively high A\$63/t – Figure 5.

**Figure 5: Lanco Resources Coal Production and Value (A\$ per tonne)**

Half ended 30 Sept		2013	2014	Change yoy
Coal Production	(Mt)	1.48	1.34	-9%
Coal Sales	(Mt)	1.62	1.34	-17%
Coal Value	(A\$/t)	43.51	44.47	2%
Cash cost of production	(A\$/t)	66.47	62.75	-6%
Revenue	(A\$m)	70.5	59.6	-15%
EBITDA	(A\$m)	-37.2	-24.5	n.a.

Source: Lanco Infratech Media Release, 14 November 2014, IEEFA calculations

## Section 7: Griffin Coal – Balance Sheet

Griffin Coal's Australian parent entity is Lanco Resources Australia Pty Ltd. Figure 6 details the consolidated net debt of Lanco Resources Australia. As at March 2012 net debt was A\$708m, 358% of the book value of equity held in the Australian group. Given the group has reported a net loss in each of the preceding two years (excluding director revaluations), and a net loss of A\$35m in 2011/12, the Australian group's financial position was stressed at that time.

The subsequent collapse of international thermal coal prices, down 50% to US\$63/t by November 2014 (for the Newcastle benchmark index), and the ballooning losses from the Australian subsidiaries, barring an equity injection from the Indian parent group, the shareholders funds of Lanco Resources Australia would be approaching zero by March 2014. We note that as of our last review in November 2014, no subsequent financial accounts for the Australian financial entities have been lodged with the Australian Securities and Investment Commission (ASIC) since 2011/12.

**Figure 6: Lanco Resources Australia P/L - Net Debt and Equity (A\$m)**

Year ended March	2011	2012
Long term debt	651	582
Short term debt	24	134
Less cash	-46	-8
<b>Net debt (A\$m)</b>	<b>629</b>	<b>708</b>
<b>Book value of Equity (A\$m)</b>	<b>178</b>	<b>198</b>

Source: Lanco Resources Australia Pty Ltd 2011/12 financial accounts

## Section 8: Griffin Coal – a A\$1bn, 15Mtpa Greenfield Coal Port

### Background to Coal Export Facility

In September 2011 the WA Environmental Protection Authority approved Lanco Resources Australia Pty Ltd's Environment Scoping Document for the Bunbury Coal Storage and Loading Facility. This approval allowed the construction of a 15Mtpa coal export terminal in the inner harbour of Bunbury port, plus construction of a rail loop and the associated dredging of 2Mt. The approval allowed for offshore dumping of spoils in Commonwealth waters. Construction was reported to take 18 months post regulatory approval.

The public Environmental Review was due to be completed in second quarter 2012 but was only released for public review in November 2012 by Parsons Brinckerhoff.<sup>xxxii</sup> This saw an initial 1Mtpa export proposal with the aim to expand this to 15Mtpa of export capacity.

Lanco Infratech viewed Griffin Coal as being in a strategic location, given the Bunbury port is 90 km from mine, there was existing connectivity via rail and the West Australian government was keen for mining sector expansions. Lanco Infratech envisaged a vertically integrated West Australian coal mine to Indian coal-fired power plant operation. However, the depreciation of the Indian Rupee over 2013/14 has significantly undermined the commerciality of this proposition.

In June 2013 the West Australian Environment Protection Authority recommended approval of the Bunbury port coal terminal.<sup>xxxiii</sup>

### June 2014 Approval for a 15Mtpa Bunbury Coal Export Facility

Despite no apparent ability to fund a massive expansion, Griffin Coal management continue to claim the company is on track for construction if its coal export facility and mine expansion, claiming in July 2014 that the company expects to see construction commence in 2015. Given the parent company's US\$6bn of consolidated net debt, the corporate debt restructuring program under way in India, plus the continued gross operating losses of Griffin Coal and the A\$150m final payment due to the Australian creditors in February 2015, it seems of questionable merit for directors to allow this group to continue to make such claims. Directors might be better served focusing on the more immediate question of fiduciary duties relating to going concern laws.

### Port Expansion Capital Cost – A\$1bn

Press reports suggest the 15Mtpa coal export facility would involve a capital cost of A\$1bn<sup>xxxiv</sup> to A\$1.2bn.<sup>xxxv</sup> The latest coal export facility in Australia is the Wiggins Island Coal Export Terminal (WICET), under construction currently at a cost exceeding A\$3bn for a 27Mtpa facility. This would imply a capital cost of over A\$1.5bn for Bunbury. However, IEEFA expects that cost savings derived from the absence of a long trestle and likely savings post the deflating of the resources boom suggests the low end of the range at A\$1bn is probably in the ballpark.

There was one unattributed cost estimate reported in the press at \$500m in July 2014.<sup>xxxvi</sup> We have not been able to reference any formal estimate of this capital cost in Lanco Infratech's annual reports.

In June 2014 the West Australian Environment Minister Albert Jacob approved the Bunbury Port development and associated dredging.<sup>xxxvii</sup> The Minister clearly made no evaluation of the project's commercial viability nor seemed to consider the remote prospects of the project reaching financial close given Lanco Infratech's overall and Griffin Coal's local financial position.

## **Commercial Viability**

The commercial viability of a A\$1bn greenfield export facility at Bunbury is questionable on our analysis of the limited financial information available. Given Griffin Coal is running at an annual cash loss on revenues of A\$42/t, implying the gross cash operating costs of the mine have ballooned to over A\$60/t (refer Figures 4 and 5). Add in rail and port charges approaching a combined A\$10/t, plus ocean freight costs of A\$10/t would suggest an landed cost in India of say A\$80/t or US\$70/t.

This US\$70/t is close to the Indian landed cost of Newcastle benchmark coal currently at US\$75/t (US\$62/t plus around \$12/t ocean freight). However, the energy content of Collie coal is estimated to be 20% below the Newcastle 6,000kcal net as received (NAR) benchmark. As such, the value of the Collie coal would be around a 20% below benchmark.

Various reports put Collie coal thermal energy around 4,400-4,800kcal. The Geoscience Australia website quotes Collie coal at around 4,350kcal.<sup>xxxviii</sup> Platts reported Collie coal at 4,700kcal gross as received (4,400kcal net as received).<sup>xxxix</sup> Griffin Coal's website refers to their coal as sub-bituminous coal or 'black lignite', quite high in moisture.<sup>xl</sup> A WA government resource presentation puts Collie coal at 4,700-4,800kcal (20Mj/kg).<sup>xli</sup>

The Collie basin coal is however quoted as well below benchmark ash content, with the WA Government estimating 6% ash.

With a landed cost in India of A\$80/t for Collie coal, this suggests the current thermal price of Newcastle benchmark exports would need to rise over 20% to allow the mine to achieve a gross cash breakeven. Clearly Lanco Infratech would expect to deliver some significant economies of scale if production of Griffin Coal was quadrupled, but this all suggests the export project is not only unable to be financed by Lanco Infratech, but it is also uncommercial near current thermal coal export prices.



## Section 9: Griffin Coal – Unfunded Mine Remediation Provisions

The March 2011 accounts of Griffin Coal show an environmental bond of A\$255,000, down from A\$369,000 the previous year. Against this, the mine remediation provision was A\$21,877,000, up from \$20,932,000 the previous year.

The environmental bond held by the West Australian government to cover mine remediation therefore represented just 1.2% of the 2011 estimated mine remediation provision of Griffin Coal.

As of March 2012, the environmental bonds remained A\$255,000 relative to the \$20,558,000 provision for remediation. We note that Griffin Coal directors approved an unexplained downward revision of costs for mine rehabilitation of \$672,000 and lowered the discount rate applying to the remediation provision, again lowering the total provision by another \$716,000. No increase in the provision for 2011/12 was booked despite the mining of 3.0Mt during the previous financial year and the capitalisation of \$25m of costs relating to additional overburden removal during the period.

Because more recent financial accounts have not been lodged with ASIC, we are not able to give a more current estimate of the unfunded remediation liabilities of Griffin Coal. However, given a mine life of well over 20 years, and production of 3-5Mtpa and a conservative remediation provision of A\$1-2/t, this suggests the Director's estimate is extremely conservative.

However, using the Director's own estimate, there is an unfunded mine rehabilitation liability of more than A\$20m outstanding. Should Griffin Coal be placed in receivership, this liability could ultimately be borne by West Australian tax payers. While this may be viewed as extreme scenario, the existence of 50,000 disowned and un-remediated mine sites across Australia suggests this outcome has been reached many times before.<sup>xliii</sup>

We understand the Collie mines are under State Agreement Acts and as such have no bond requirements.

IEEFA would strongly endorse increasing the environmental bond requirements for all companies undertaking mining in Australia along the lines of the Mining Rehabilitation Fund Act 2012. Bonds held by the State governments should at least equal the provision for mine rehabilitation carried by the mining companies (or alternative would be for an external calculation of the rehabilitation cost). Interest received on these bonds could then be applied to gradually fund the remediation of some of the multitude of abandoned and dangerous mine sites across Australia, many of which are leaching toxic chemicals into the Australian water systems.

A key part of the Collie community transition plan could be the retraining and employment of the existing miners in an extended program of rehabilitation.

## Section 10: Griffin Coal – Australian Auditor Resignation

The 2013/14 annual report of Lanco Infratech carries a cryptic comment about the “Qualification of Unaudited financials of SPV’s consideration in Consolidation”.<sup>xliii</sup>

The key comment in this paragraph is that Lanco Infratech’s auditor has qualified the Indian group accounts because certain Lanco Infratech subsidiaries have been consolidated into the group accounts but have not been audited for the current 2013/14 year.

No mention is made that the Australian auditor, Ernst & Young had resigned three weeks before year end, nor any explanation as to why the auditor had resigned.<sup>xliiv</sup> At the time of our review of the ASIC website into Lanco Infratech’s Australian subsidiaries in November 2014, we could not find any reference to the appointment of a new auditor, making the claim that the audit of the current year is underway hard to follow.



Cover picture links to annual report

However, we note that the interim 2014/15 accounts of Lanco Infratech released on 14 November 2014 mention that the Griffin Coal accounts for 2013/14 have now been audited.

## Section 11: Yancoal Australia's Premier Coal

### Yancoal Australia – Acquisition of Premier Coal 2011

In September 2011 Yancoal Australia acquired the Premier Coal mine from Wesfarmers<sup>xlv</sup> for a reported A\$297m.<sup>xlvi</sup> Premier Coal produced 3.5Mtpa of thermal coal for sale in Western Australia, primarily to Verve Energy, the state owned power generation company.

As of the 2010/11 financial year, the consolidated revenue for Premier Coal was A\$143m, and earnings before interest and tax (EBIT) were A\$11.5m. Yancoal paid more than twice revenue and 26 times historic EBIT of Premier Coal, an exceptionally full price at the time. This also marked the peak of the global coal boom, and with the collapse of the coal price thereafter, the acquisition pricing looks excessive in hindsight.

However, in contrast, only eight months earlier Lanco Infratech paid more than double this for Griffin Coal, a business that was marginally smaller, more rundown and materially less profitable than Premier Coal.

### Yancoal Australia - Financially Leveraged

Yancoal Australia Ltd (Yancoal Australia) is 78% owned by Hong Kong and Shanghai listed Yanzhou Coal Mining Company Ltd (Yanzhou Coal) of China. Yanzhou Coal's 53% controlling shareholder is the state owned Yankuang Group Company Limited.

Yancoal Australia is excessively financially leveraged courtesy of the ill-timed acquisitions of Felix Resources for \$3.5bn in 2009<sup>xlvii</sup>, Gloucester Coal for \$2.1bn in 2012<sup>xlviii</sup> and several other smaller coal businesses. Yancoal Australia's share price has lost 90% of its value since 2012.

Yancoal Australia is also one of the seven remaining founding investors in the 27Mtpa Wiggins Island Coal Export Terminal (WICET) in Gladstone, Queensland. WICET is likely to prove to be the most expensive coal export terminal built ever built in Australia, costing over \$3bn or A\$122m per tonne of export capacity and charging upwards of A\$13/t of coal. Yancoal Australia has a long term 1.5Mtpa take-or-pay liability associated with WICET for its Yarrabee coal mine.

Yanzhou Coal as at the end of 2013 had provided \$1.9bn of intercompany loans to Yancoal.<sup>xlix</sup>

In November 2014 Yancoal Australia announced an extremely dilutive US\$2.3bn subordinated convertible notes raising at 7% pa yield and convertible at US10c per share.<sup>!</sup> Yanzhou Coal has announced it will subscribe for its full entitlement. The proceeds will be primarily used to repay outstanding loans owed by Yancoal Australia to Yanzhou Coal.

## Section 12: Yancoal Australia's Premier Coal – A Logical Acquirer

### Griffin Coal – For Sale

As part of the corporate debt restructuring agreement of December 2013, Lanco Infratech agreed to sell projects and subsidiaries. In January 2014 it was reported that this included Griffin Coal.<sup>li</sup> At the same time it was reported that Nagaprasad Kandimalla, CEO of Griffin Coal, had resigned.

A number of factors conspire against any sale of Griffin Coal:

1. The depressed state of the global seaborne thermal coal markets, with potentially a permanent, structural decline in demand;
2. The lack of large scale coal export facilities;
3. The lower than benchmark energy content of the Collie Basin coal;
4. The loss-making state of the business for much of the last five years;
5. The long term fixed price nature of the domestic coal supply contracts in Western Australia;
6. Existing debts secured against the Australian coal business (possibly as much as US\$663m);
7. A \$20m+ unfunded mine rehabilitation charge outstanding; and
8. A \$150m final payment due February 2015 to the creditors of the last insolvent business structure that owned Griffin Coal.

IEEFA would be surprised if there were many potential buyers of the Griffin Coal business in its current state. A return to voluntary administration is an increasingly likely eventuality given we would estimate that with a negative EBITDA and significant net debt, the Australian subsidiaries have a negative equity value approaching the sum of the debt and the rehabilitation liabilities combined.

### Yancoal Australia – Premier is a Logical Buyer, at a price

Should Griffin Coal return to voluntary administration, the corporate structure can be stabilised through heavy collective write-downs of the existing financial liabilities.

Notwithstanding the excessive financial leverage of Yancoal Australia, there remains a commercial imperative that neither Premier Coal nor Griffin Coal are making even remotely acceptable returns.

One logical buyer of the Griffin Coal mine is Yancoal. Any such proposal would have to be approved by the Australian Consumer & Competition Commission (ACCC). Extensive negotiations with the ACCC and the Western Australian government would be required to allow such a takeover, given it would facilitate the creation of effectively a Western Australian thermal coal monopoly.

However, a key consideration would be the need to protect as many of Griffin Coal's 200-300 local Collie employees to the extent possible. A merger of these two businesses could allow some material cost-down synergies through economies of scale,

rationalization of plant, offices and management, saving a number of jobs for the longer term and ensuring continuity of domestic coal supply.



Pit 5 at Premier Coal in Collie. Source: SK - ABC Local

## Section 13: Yancoal - Western Australian Government's 2014 Coal Bailout

In October 2014 the West Australian Energy Minister Mike Nahan announced he had agreed to give Yancoal Australia's Premier Coal what was reported as a \$15m per annum price rise.<sup>iii</sup> Despite the fact that the West Australian government was effectively bailing out a Chinese state owned entity from a very expensive peak cycle acquisition of 2011 gone bad, few details have emerged as to the full terms.

We understand that under its prior owners Wesfarmers, Premier Coal had entered into a new 20 year coal supply agreement with the West Australian government's power utility Synergy in 2005, with the contract starting in 2011. Due diligence would have meant that this contract was fully known at the time Yancoal Australia acquired Premier Coal. Over the remaining 16 year contract, if the press reports are correct, this looks like a subsidy of potentially \$240m that will be funded by all south west West Australian electricity users.

Put another way, on our understanding of the government disclosures, this government subsidy is effectively making taxpayers fund over \$50,000 per annum for each job protected.

With Griffin Coal in far worse financial and operating shape than Premier Coal, the question is likely to be asked: is the Energy Minister is now going to offer a similar subsidy to Lanco Infratech?

IEEFA is of the view that bailouts like this are ultimately going to prove futile. The West Australian government would be better off using any restructuring and administration process to develop an alternative long term energy plan that helps the economy and local Collie community transition towards a low carbon future and creates new jobs in emerging, high value industries of the future.

In November 2014 the opposition party leader Mark McGowan called on the West Australian government to offer Griffin Coal a royalty holiday or other form of subsidy, suggesting this would protect employment.<sup>liii</sup> Given the financial leverage attached to the Australian business, and the extent of the operating losses, Griffin Coal will need a lot more than a royalty holiday to restore financial viability on our analysis of public records.

### **Propping Up a Stranded Asset**

The West Australia (WA) State Government continues to have a 'dual fuel' policy, resulting in over \$1bn investment in redundant energy generation infrastructure in WA due to government created perversities in the energy market (catering for a projected demand increase which have proven over optimistic), with demand reductions in response to higher electricity prices and the increasing usage of solar. With the high solar radiation, high electricity prices and high penetration of gas-fired power generation to cope with high peak demand, the commerciality of coal fired power generation is increasingly under threat from reduced 'base-load' demand.<sup>liiv</sup>

Taxpayer monies would be better spent on mine rehabilitation and developing renewable energy projects to leverage the existing grid infrastructure and develop new skilled employment opportunities. A plan for transition would be a good start.

## **Section 14: Similarities -Lanco Infratech vs Adani and GVK**

While there are differences between Lanco Infratech's Australian coal foray and that being undertaken by the GVK and Adani Groups, there are also striking similarities. The parallels include:

**Conglomerates:** All three groups are Indian conglomerates with operations spanning a multitude of industries. Asset exposures range from coal and gas fired power stations and hydro electricity, property development, trading, toll road, rail and port infrastructure projects as well as airports. The operational issues for each business are diverse and do not readily facilitate the establishment of a core area of business expertise.

**Excessive Greenfield Expansions:** All three groups have undertaken a myriad of greenfield project developments across a variety of industries concurrently. All three have experienced a multitude of unexpected delays often with a number of projects stalled or delayed.

**Excessive leverage:** All three groups have expanded rapidly over the last five years, with gross assets and hence net indebtedness expanding to be multiples of the equity base of the individual groups. Given a doubling, trebling or even quadrupling of debts in less than five years, and the miss-match of US\$ borrowings against Indian Rupee revenue streams, the greenfield expansions' cash generation has failed to grow at the same rate as net cash interest expense incurred (both that expensed through the income statement plus that capitalized onto the balance sheet instead).

**Expansion abroad at pace:** Each of the three groups were operating in substance only in India prior to 2009. All three expanded via acquisitions in coal mining and associated infrastructure in Indonesia and / or Australia over 2009-2011. Lacking any prior exposure to coal mining in India, all three paid top prices to acquire strategically challenged coal mining project proposals at the peak of the coal boom. Two of the three have deferred acquisition consideration that is either unpaid or at risk.

**State government support:** All three Indian conglomerates have seen positive endorsements, approvals and regulatory support from their respective Australian state governments, despite bringing almost no equity capital to their respective project proposals (we note the \$5bn of combined debt amassed by the three groups in total against their Australian proposals), and despite their clear inexperience in coal mining. State premiers, government ministers and mining lobby groups have all shown an uncanny willingness to endorse projects of questionable financial merits as well as providing regulatory and/or Australian taxpayer funded financial support, undermining the interests of local Australian landowners.

**Unexpected delays:** All three Indian firms have continued to make regular statements of their intent to develop coal project proposals only to see timetables consistently slip year after year. Given the magnitude of each greenfield coal mine project relative to the limited financial resources available to the respective companies, financial close in each case has unsurprisingly proven to be elusive.

**Senior management turnover:** All three have seen the Australian Chief Executive Officer replaced in the last year or so.

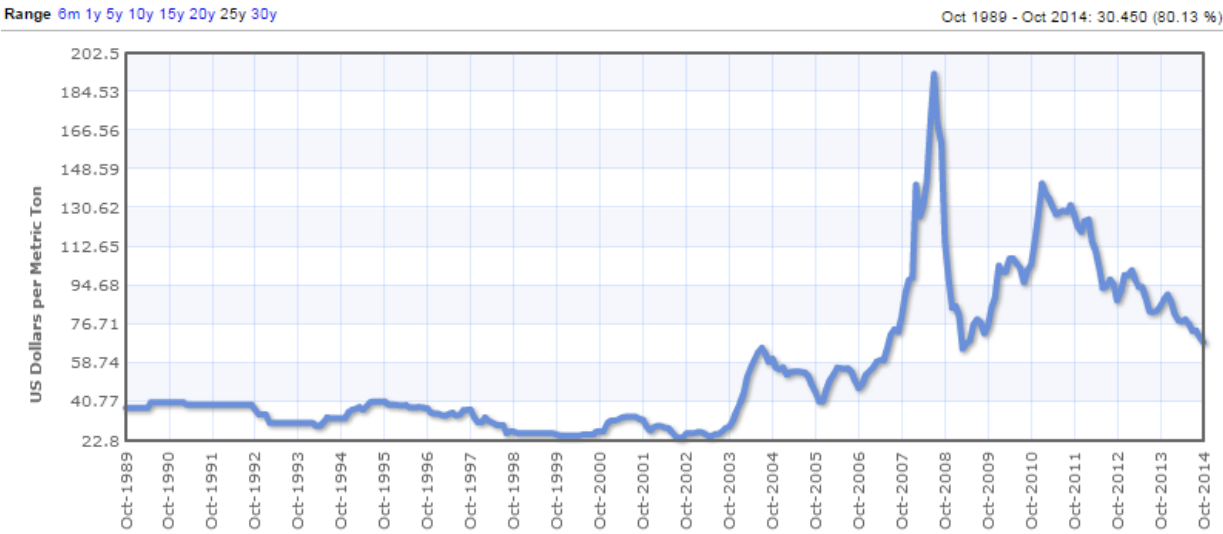
**Low quality coal deposits:** All three firms are pursuing coal project proposals that involve low quality coal with lower than benchmark energy contents, and where the necessary established infrastructure is absence.

# Section 15: Thermal Coal Prices

The seaborne thermal coal market has seen a massive correction since 2008, with thermal coal prices down 65% - refer Figure 7. IEEFA would argue this reflects the combined impact of significant over build of new capacity in coal mining globally over 2010-2014 plus a rapid deceleration in the rate of growth in global demand. IEEFA forecasts that global demand for coal will peak by 2016, and gradually decline thereafter. This would leave the seaborne thermal coal market in structural decline, such that industry profitability will remain below sustainable levels for some time to come.

The inevitable outcome of this will be progress mine closures globally, lower real wages for coal miners and a significant lift in productivity in order to drive down cash operating costs on those mines that remain. Lower cash costs of operation will mean the clearing price is likely to be lower than general market expectations for some time to come. IEEFA forecasts a long term thermal coal price of US\$75/t (as defined by the Newcastle benchmark). For more details, refer the September Carbon Tracker/ET-Advisers/IEEFA Global Coal Review.<sup>iv</sup>

**Figure 7: Newcastle Benchmark Thermal Coal (1989-2014, US\$/t, FOB, 6,000kcal NAR)**



**Description:** Coal, Australian thermal coal, 12000- btu/pound, less than 1% sulfur, 14% ash, FOB Newcastle/Port Kembla, US Dollars per Metric Ton

Source: <http://www.indexmundi.com/commodities/?commodity=coal-australian&months=300>



## Section 16: Conclusion

This report evaluates the circumstances of the Griffin Coal Mine in Western Australia to illustrate a series of parallels between three major Indian conglomerates that invested in Australia's coal industry at the top of the mining boom in 2011. Lanco Infratech, Adani Enterprises and the GVK Group have each invested substantial capital in Australian coal projects that require billion dollar greenfield infrastructure developments.

All three proposals face significant financial challenges, not the least being the excessive reliance on unhedged debt financing both at the time of acquisition and subsequently in trying to raise additional funding to develop greenfield mine and associated infrastructure projects.

With the emergence of a significant shift in the global energy market structure since 2011, IEEFA views the thermal seaborne coal market as having entered structural decline. The Australian benchmark thermal coal price has fallen over 50% since 2011, and listed coal companies equity prices have followed this trend, with declines of 60-90% common. This has raised the key financial risk of stranded assets in the coal mining and associated rail and port infrastructure sectors.

Lanco Infratech is undertaking a corporate debt restructuring program with its bankers, involving extending credit facilities in return for a commitment by Lanco Infratech to divest assets and pay down debts. 2014 has seen Lanco Infratech make solid progress in India to this end. In contrast, IEEFA views Lanco Infratech's Australian Griffin Coal as a potentially stranded asset. Being overgeared and loss-making at the gross cash operating level, the current business viability is questionable.

IEEFA analyses the current situation with respect to Griffin Coal to illustrate three wider policy points. These are:

1. The need for a long term energy plan that evaluates economic and community transition needs;
2. The increased reliance on taxpayer subsidies to support the coal industry; and
3. The risk to taxpayers from the current underfunded state of mine rehabilitation bonds. The current situation means that if a coal company fails, the community is left to fund the substantial mine remediation costs.

## Important Information

This report is for information and educational purposes only. It is for the sole use of its intended recipient. It is intended solely as a discussion piece focused on the topic of the Australian coal industry and the risks of stranded assets. Under no circumstance is it to be considered as a financial promotion. It is not an offer to sell or a solicitation to buy any investment referred to in this document; nor is it an offer to provide any form of general nor personal investment service.

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<sup>iii</sup> Lanco Infratech Investor Presentation, August 2013.

<sup>iv</sup> Lanco Infratech Interim result to September 2014:

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<sup>v</sup> <http://www.businessweek.com/news/2013-12-30/singh-s-160-billion-logjam-saps-lanco-earnings-corporate-india#p2>

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<sup>xiii</sup> <http://www.smh.com.au/business/farewell-to-fortune-as-creditors-close-in-20100224-p3in.html>

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<sup>xvi</sup> Lanco Infratech Annual Report 2013/14, page 105.

<sup>xvii</sup> <http://www.businessweek.com/news/2014-01-09/lanco-said-to-consider-sale-of-australian-griffin-coal-division>

<sup>xviii</sup> Lanco Infratech Investor Presentation, August 2013.

<sup>xix</sup> [http://www.epa.wa.gov.au/EIA/EPARports/Documents/1486/Volume%201\\_PER\\_2162530A-PR\\_5797\\_RevB.pdf](http://www.epa.wa.gov.au/EIA/EPARports/Documents/1486/Volume%201_PER_2162530A-PR_5797_RevB.pdf)

<sup>xx</sup> Lanco Infratech Annual Report 2013/14, page 22.

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