IIFL SECURITIES

14th October, 2020

To
The Secretary,
The PNGRB
1st Floor, World Trade Centre
Babar Road, New Delhi - 110001

Respected Ma'am/Sir

Subject: ***Views/comments on the draft 'PNGRB (Determination of Transportation Rate for CGD and Transportation Rate for CNG) Regulations, 2020'***

We, the undersigned, wish to submit our views/comments on the aforementioned subject; please find attached the same.

We request you to take these on board and allow us to participate in the open house, to be conducted on 16th October, 2020.

We thank you in advance for affording us this opportunity.

With kind regards.

Yours faithfully,

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Comments on PNGRB's draft regulations:

We present our views, as analysts and investors covering the oil & gas sector.

We believe a competitive environment is good for the sector, as it helps improve efficiency and quality of service for the end-consumer; this is visible is Telecom, Banking, Insurance, etc. And to that extent, PNGRB's intent to introduce competition in CGDs will help enrich the sector.

We wish to comment/extend suggestions on the rate of return and the method to determine it. Our views are intended more to facilitate greater acceptance of competition by incumbent players, rather than prolonged litigations, which can stall investments in the sector and delay the intended goal of improving gas penetration in the overall energy basket.

We understand that the open house aims to only address tariff regulations; however, we take the liberty of highlighting a few related-issues, which have a bearing on the overall economics of the business. We shall make our submissions in the relevant forum as well.

Rate of return:

The tariff regulations under discussion are applicable for a sub-set of the industry, albeit, they will set the tone for attracting further investments and capital formation. This is because volume growth, profits, cash-flows and resultant return ratios are considered a benchmark by several other investors, who plan to infuse funds or scale up their investment in the sector. And to that extent, such entities are the 'brand ambassadors' that can enable significant capital formation in the Oil & Gas sector, at attractive terms.

As per various media interviews of the Hon. Minister of MoPNG and the Hon. Chairman of PNGRB, CGD entities are expected to invest Rs800-900bn over the next few years, to set up a gas-retailing infrastructure. It is estimated that on the traditional 70/30 D/E mix, an approximate Rs240-270bn equity is required, for the purpose of achieving financial closure for projects in general; a conservative D/E (50/50 mix) will imply an even higher equity contribution.

As your good selves are aware, during the recently-conducted CGD bids, several new players have won CGD licences. Some of these successful bidders plan to raise equity capital for completion of projects.

We would like to highlight that while raising such equity capital, CGDs are competing with high-growth, high-RoCE companies that operate in free markets, which can potentially give significantly higher returns.

This is at a time when internal compliance driven by ESG frameworks (Environmental, Social and Governance) of large investors is compelling them to reassess the existing as well as new investments in traditional hydrocarbon and hydrocarbon value-chain companies.

The cost of doing business for infrastructure companies has increased domestically, given delays in securing permissions and right of way; it is expected that COVID may bring lasting changes in the working styles of several organisations which will weigh high on the personal mobility segment – key for CGD entities.

The Government of India, meanwhile, is extending subsidies for the promotion of alternatives, such as Electric Vehicles (EVs); faster penetration of EVs will test the efficiency of hydrocarbon-based fuel retailing revenue models.

Such factors pressurise the expected rate of return by investors and, in such times, there is a risk of significant challenges in capital formation if these entities do not get regulatory support; pulled down by these obstacles, several projects have not been able to take off at all.

To help ease such pressures for the industry, we believe that rather than enforcing a regulated rate of return, the market should be allowed to discover a premium over & above the base tariff, as prescribed by the PNGRB. This will meet the objectives of the overall stakeholders – consumers, incumbent players and new entrants.

The PNGRB may also consider increasing the base returns, from 12% post-tax RoCE to >16%, to ensure that the attractiveness of the business remains intact.

Benefits of market-determined returns:

Price alone should not be the sole driver of introducing competition and ought to include two other factors: quality and reliability of services.

The market-discovered tariff will offer fair risk-reward for the incumbents, thereby allowing network access in spirit, rather than blocking access on several technical grounds.

Such market discovered tariff will allow the new entrants to base their business plans on quality of services, reliability rather than pricing alone.

With more than one supplier to choose from, consumers would eventually procure better prices, reliability and services – which is the prime objective of the PNGRB regulations.

As such, tariff determination by the market through competitive bidding bodes well for all.

The Government of India is also doing away with determining price of natural gas produced from new & difficult fields and would allow players to sell gas through competitive bidding. Also, introduction of bidding by the PNGRB would be in sync with the Government policy initiative, to dismantle the regulated pricing mechanism.

Several platforms to conduct bidding:

The bidding could be conducted through a portal on the lines of MSTCE's Deep Portal (https://www.mstcecommerce.com/auctionhome/ppa/index.jsp). This portal is operated by MSTC and PFC Consulting and allows state-owned discoms to call for short/medium term power purchase bids. The system has been operating well, and seems to have truly narrowed the price gap between bilateral contracts and the spot market. Alternatively, platforms such as IGEX can also develop such a mechanism.

One may argue that the entities that have been in the business, even pre-PNGRB, may continue earning "super normal" returns and such returns are well ahead of that of some other players in the value chain. We agree that such divergence may persist; and this may have to be looked at, in the larger interest of sectoral development. As is, in such areas, state governments are aggressively introducing EVs which is likely to moderate returns in the medium-to-long run for them.

Related issue – Gradual introduction of competition essential

Consumers are already paying for full capacity, including unutilised capacity in the network, if any. So the focus, while introducing competition, should be on improving capacity utilisation which can bring down per-unit costs.

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Such an approach will not be cost-additive for consumers, but help set the benchmark for quality and service; and, with multiple players in operation, it will assist in improving utilisation of infra capacity.

In this context, we would like to bring to your notice the draft on access code (*as it is a related issue, we are stating it here*) – for existing consumers, there is no barrier to migrate to a new supplier. While such choice should be with the consumer, in our view it seems slightly premature for healthy competition, which is based on three aspects – quality of service, assurance of supply, and pricing (as aforementioned).

While a new entrant may be able to offer efficient pricing, the consumer may take time to establish confidence on quality and reliability and, to that extent, only price should not be the sole driver of consumer migration. Hence, a calibrated move towards migration of the consumer be allowed, albeit not from Day-1; such a move may allow an authorised entity to raise the bar on the quality of service and reliability, in addition to pricing.

We shall elaborate on this issue during the discussion on the access code.

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