



Petroleum and Natural Gas Regulatory Board
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Public Notice

The Board invites suggestions, comments from all stakeholders and experts on the attached document titled “Concept Paper on unbundling of activities of transportation and marketing of natural gas” by 15th October 2012. The comments/views may be sent by e-mail to secretary@pngrb.gov.in and/or by post addressed to Secretary, Petroleum & Natural Gas Regulatory Board, 1st Floor, World Trade Centre, Babar Road, New Delhi 110001.

(Ratan P Watal)
Secretary

**CONCEPT PAPER ON UNBUNDLING OF ACTIVITIES OF TRANSPORTATION
AND MARKETING OF NATURAL GAS**

1. Existing provisions:

1.1. The PNGRB Act, 2006 and the Policy of the Central Government titled “Policy for Development of Natural Gas Pipelines and City or Local Natural Gas Distribution Networks” issued on 20.12.2006 contain the following provisions in respect of unbundling of the activities of transportation and marketing:

PNGRB Act, 2006

21. Right of first use, etc.-(1) The entity laying, building, operating or expanding a pipeline for transportation of petroleum and petroleum products or laying, building, operating or expanding a city or local natural gas distribution network shall have right of first use for its own requirement and the remaining capacity shall be used amongst entities as the Board may, after issuing a declaration under section 20, determine having regard to the needs of fair competition in marketing and availability of petroleum and petroleum products throughout the country:

*Provided that in case of an entity engaged in both marketing of natural gas and laying, building, operating or expanding a pipeline for transportation of natural gas on common carrier or contract carrier basis, the Board shall require such entities to comply with the affiliate code of conduct as may be specified by regulations and may require such entity to **separate the activities of marketing of natural gas and the transportation including ownership of the pipeline within such period as may be allowed by the Board and only within the said period, such entity shall have right of first use.***

Policy of the Central Government

6. UNBUNDLING OF OPERATIONS

6.1 Any entity desirous of applying for building, operating or expanding common or contract carrier gas pipelines will have to give an undertaking that if such an entity has business interests in related areas of gas marketing or city or local gas distribution network or has a related entity (e.g., a parent company, group company, company under the same management, JV company, subsidiary or affiliated in any way to create a pecuniary interest) with business interests in such areas, it will ensure an arm's length relationship between gas pipeline activity and these activities or between itself and the related entity as the case may be.

Under such conditions, an Affiliate Code of Conduct between the authorized and related entities or between the gas pipeline activity and other activities of the authorized entity, as formulated by the Board under the regulations will have to be followed. Any existing entity engaged in gas pipeline activity, which has business interests in related areas of gas marketing or city or local gas distribution network, will follow a similar Affiliate Code of Conduct. The Board will have the right to enquire about the managerial structure/ownership pattern and accounts of the authorized entity and its related entities to determine that such a relationship is actually at arm's length. For this purpose, the Authorized entity shall produce relevant records/documents in respect of itself as well as the related entities for examination by the Board, as and when called for.

*6.2 In the long run and with the maturing of gas markets, it is envisaged that the authorized entities will have transportation of natural gas as their sole business activity and will not have any business interests in the gas marketing or city or local gas distribution networks. **Thus, the Board may***

intervene at an appropriate stage to ensure unbundling of transportation activity from other activities of the entity.

6.3. The purpose of this policy is to ensure that pipeline ownership does not provide any competitive advantage to any gas seller and abuse of market power while establishing an efficient gas grid with open access for all the players on a non discriminatory basis.

1.2. It is evident from the above that the legislative framework provides sufficient powers to the Board to not only ensure separation of activities of transportation and marketing but also decide the nature and time-lines for the same.

2. Why unbundling?

2.1. Monopoly behaviour is anti-competitive and therefore not in consumer interest. But the policy pronouncement of the Central Government dated 20.12.2006 itself states that in many areas there exist some areas of monopoly where the benefits of regulation potentially outweigh the costs. Therefore effective monitoring of a monopoly through an appropriate regulatory framework is essential if benefits are to be ensured for consumers.

2.2. In case of a monopoly which provides a variety of services, splitting it vertically along the gas value chain is the end towards which all regulators in developed gas markets have endeavored and also reached. Simply put, what is meant here is that where monopoly and non-monopoly services are offered, splitting them into two parts is the objective of regulators in different parts of the world.

3. Format of unbundling

3.1. Accounting segregation:

- (a) An essential ingredient of any effective regulatory framework for infrastructure service is the arrangement, which enables the system to generate accounting statements for regulatory and management purposes. This creates capabilities of analyzing costs, revenues and capital employed in major areas of an entity's business. Failure in designing appropriate accounting procedures is often one of the key reasons for not realizing the potential gains of restructuring the sector by opening it up to competition. Working out the cost of providing a particular service is, therefore, the first and most important step in creating a fair, transparent and just regulatory environment.
- (b) Under the system of accounting separation, an entity and affiliates as well as various divisions within an entity shall be obligated to maintain separate books of accounts with arm's length relationship between the two in all financial transactions of purchase and sale, pricing, incurring costs, acquisition / disposal of assets, investments, transfer of profits etc.

3.2. Legal Segregation:

Under this system, the aim and objective is to create separately identifiable legal entities along functional lines i.e., production, transportation, marketing of natural gas etc. Some examples of entities that could be construed to have been set up as separate legal entities with activity of transportation as their sole business activity comprise RGTIL and GSPL.

3.3. Ownership and Management control segregation

This structure envisages that the entity and its affiliates do not have common ownership as visualized under the proviso to section 21 of the PNGRB Act, 2006.

Management control segregation would ensure that independent decision making processes exist in the entity and its affiliates.

4. Which Type and at What Stage

4.1. As per the provisions of section 21 of the PNGRB Act, 2006, the right of first use is only available to an infrastructure owner during the time-period when the unbundling process does not take place. Creation of right of first use is critical for infrastructure development as it incentivizes laying, building, operating or expanding the infrastructure by guaranteeing access to the owner. As per the provisions of the extant PNGRB regulations, right of first use is not deemed to be preferential access. Therefore, the level of infrastructure maturity, market depth and timing are important factors that should influence the decision making for unbundling.

4.2. Accounting segregation is generally accepted as first stage in unbundling and exists in pre-trading gas market. The legal system's delivery mechanism, sophistication of corporate laws, minority shareholder rights and corporate governance issues should ideally decide the subsequent stages of unbundling.

5. Present situation

5.1. The Board has notified the affiliate code of conduct for entities engaged in the activity of transportation of natural gas by common or contract carrier natural gas pipeline and marketing of natural gas. The "code" sets out the manner of the –

- (a) Interactions between the entity and its affiliate for the purposes of carrying out the activities of both transportation and marketing of natural gas based on the principle of "at an arm's length"; or
- (b) Engagement in both the activities of transportation and marketing of natural gas by the entity on its own by following the principle of "at an arm's length".

- (c) The objectives of this code are to ensure-
- (i) Protection of the interests of the consumers and other entities against the actions of an entity while dealing with its affiliate as also when the entity on its own is engaged in both the activities of transportation and marketing of natural gas;
 - (ii) Prevention of cross-subsidization of the costs between the regulated activity and any other non-regulated activity including the activity of marketing of natural gas either by the entity on its own or through its affiliate which adversely affects or has the potential of adversely affecting fair trade and competition between the entities;
 - (iii) That there is no preferential access allowed by the entity to itself or its affiliate for the regulated activity; and
 - (iv) Development of a fair and competitive natural gas market.
- (d) Degree of accounting separation: The entity shall ensure accounting and financial separation by maintaining separate financial records and books of accounts in respect of the regulated activity in cases where-
- (i) The affiliate of the entity is engaged or proposes to engage in the marketing of natural gas; or
 - (ii) The entity on its own or proposes to engage in both the activities of transportation and marketing of natural gas; or
 - (iii) The entity shall ensure that while undertaking the accounting and financial segregation in respect of the regulated activity, both direct and indirect costs are fully allocated to the regulated activity in a transparent manner and without any cross-subsidization of costs with any other non-regulated activity.
 - (iv) The entity shall adhere to the accounting standards and guidelines of the Institute of Chartered Accountants of India as

well as the Companies Act, 1956 and the Board may, if it deems fit, examine the appropriateness of the basis of cost allocation followed by the entity.

5.2. The effectiveness of regulatory initiatives outlined above has yet to be ascertained as to whether they have been implemented fully in letter and spirit. While most entities have now shifted over to “SAP” based systems for data and accounting purposes through which enhanced focus is available on activity based costs and revenues, the effectiveness and the extent of the level of accounting separation actually carried out by each entity needs to be tested.

6. Suggested approach

(a) At the initial stage, the present level and effectiveness of the system of accounting separation for entities engaged in activity of transmission of natural gas needs to be assessed. The effectiveness of the system of accounting separation prevailing in each entity would need to be judged from its ability to facilitate preparation of the following financial statements:-

- (i) A statement, showing profit and loss account activity-wise i.e., transportation, distribution, marketing etc as well as pipeline-wise (each infrastructure).
- (ii) A statement, showing infrastructure-wise total cost of transportation and cost of other services like marketing/distribution etc.
- (iii) A statement showing allocation of common costs to various functions/services like transportation, distribution, marketing etc.
- (iv) A statement showing capital employed in a particular pipeline relating to the activities of transportation, distribution/marketing etc.
- (v) A statement showing allocation of capital employed to various activities.
- (vi) A statement showing activity-wise, infrastructure-wise fixed assets and depreciation.
- (vii) A statement showing reconciliation of activity-wise profit and loss account with the company's profit and loss account.

(viii) A statement on non-financial information if any.

(b) After ensuring stabilization of the system of accounting separation by end of FY 2013-14, the Board should pursue legal unbundling of the transportation segments of natural gas transmission entities which should be completed by FY 2015-16.

(c) During the period prior to completion of legal unbundling, Board should proactively take up initiatives towards development of trading in pipeline capacities and in natural gas with NCDEX/MCX and the stakeholders.

(d) Subsequently, Board may consider declaring a time-line for ownership/management control unbundling considering the following factors-

- (i) Time-frame for development of a gas grid and inter-connectivity of pipelines.
- (ii) Profile of next round of successful bidders in next round of NELP.
- (iii) Success of limited trading in pipeline capacity and natural gas in local markets in Gujarat, Maharashtra and elsewhere through active involvement of stakeholders like producers, consumers and infrastructure owners.

7. Views Solicited

The Board solicits factual information from stakeholders towards ascertaining the effectiveness of the level of accounting separation already carried out by entities for meeting the objectives enlisted in para 6 above. The stakeholders may also suggest improvements along-with their views on charting out the time-lines towards ensuring legal separation and ownership/management control separation through an appropriate regulatory framework.
