Indian City Gas Distribution Sector

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PNGRB's concept paper on tariff determination for CGD network, post marketing-exclusivity period: Challenges await implementation

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PNGRB concept paper on tariff determination for CGD network, post marketing-exclusivity period

The PNGRB had granted exclusive marketing rights to certain pre-existing CGD networks, post its formation, for a limited period. These CGDs have reached the end of the timeframe for exemption from the purview of a common contract carrier. Hence, PNGRB has formulated a concept paper to determine a process to open up these CGD networks to competition with the intention of promoting fair competition and efficient use of resources while also protecting the interests of the consumer. This regulation will not be applicable to entities that have pre-determined transportation rates as part of the PNGRB bidding process for authorisation, carried out in the ten rounds of bidding till now.

The proposal

The concept paper talks about two options for determining the transportation rate:

1. The Cost of Service methodology allowing for a post-tax normative return on equity of 14%. The financing of the capital employed will be considered at a 70:30 debt:equity mix and it is based on the capital employed in a particular geographic area (GA). The tariff will be as per the formula: (Normative operating cost + depreciation + RoCE, with capital employed computed as NFA + Normative WC)
2. The transparent online bidding process based on either of the following variants viz a) reserve price at Rs 30 per/mmbtu (~Rs 1.1/scm) for transportation rate applicable to PNG/CNG & Rs 2/kg (Rs 1.5/scm) for transportation rate for CNG with annual escalation and b) self-determined reserve price for both the CGD network & the CNG in line with the cost of service approach prescribed by PNGRB.

The Impact: Industrial PNG likely target for third party marketers; OMCs could be the first movers

- The regulation, once finalised, will give clarity to third party players while making their plans to offer gas supply to the GAs where marketing exclusivity has ended and the transportation rates are to be governed by PNGRB regulations. This will include major locations of Delhi (Indraprastha Gas Limited (IGL), Mumbai (Mahanagar Gas Limited - MGL), Ahmedabad (Adani Gas Limited - AGL), other GAs in Gujarat under Gujarat Gas Limited (GGL) and some other GAs across the country.

- In an Illustration (see below - Annexure I), ICRA has analysed the impact of the above regulation on the incumbents if the Cost of Service methodology is implemented for IGL and MGL, based on FY2019 data. The findings indicate that about 65%-75% of the contribution of these entities can be met from the recovery of the network tariff. The rest of the contribution is generated from marketing/commodity margins. It indicates that a significant proportion of the profit generation can be generated from the network margin, which is not available to third parties and should be a significant disadvantage for them while attempting to offer competitively-priced natural gas to their customers. It also indicates that even if the authorised entities lose all their volumes to third party competition (which is unlikely), they will still retain 50% of their current PBDIT margins.

- Further, there are many authorised entities who have received authorisation in Bid Rounds 4-8 by bidding nearly nil network charges for third parties (Rs 0.01/scm and Rs 0.01/kg) for the entire 25-year period of network exclusivity. They will not have the cushion of network returns and will thus remain highly susceptible to third party competition in high potential GAs. Nonetheless, low volume potential in most of the new GAs will be a deterrent for third party access.

- ICRA believes that the impact of third party competition to existing operators could be more pronounced in the PNG (Industrial) segment as the larger absolute volumes and the ease of tying up directly with a group of industrial customers would be relatively easier compared to the CNG segment, where domestic gas allocation needs to be sought having a number of end-consumers. For the PNG industrial volume, large single location opportunities (Morbi, Ankleshwar-Bharuch, Ahmedabad) with high penetration of gas are attractive for competition, given they can provide cheaper gas for a longer period. Nonetheless, the CNG segment too could be vulnerable in cities where there are bulk consumers such as State Transport Corporations, which can be weaned away at a lower tariff. Key operational challenges will be the strong promoter backing of authorised players (transmission network owned by GSPL/GAIL in case of GGL, IGL, AGL and MGL) and the complexity involved in giving access to the third party in terms of the variation in gas demand, requirement of multiple contracts to be signed and determination of idle capacity in different parts of the city/region, etc. The same complexity has deterred players from exploring third-party marketing of natural gas though over the last few years, many GAs have opted out of marketing exclusivity protection.

- The oil marketing companies (OMCs) would be the most immediate interested entities for third party marketing as they have access to gas as well as an already existing network of retail outlets. The OMCs would especially be interested in direct sales of CNG in metro areas if they find it a large enough opportunity with reasonable margin. Nonetheless, as a key risk mitigant, many of the incumbent CGD operators have signed medium to long-term agreements with the OMCs for co-locating their CNG stations at attractive marketing margins; moreover, some of the OMCs are also either the majority or the minority shareholders in these CGD entities.

Conclusion: Competition from third party marketing not an immediate challenge as various operational bottlenecks yet to be resolved

- For third party competition to emerge, clarity will be required on the service obligations, as the competitors could focus only on the most lucrative consumers, while being not responsible for servicing not so profitable segments such as PNG (domestic); moreover, guidelines need to be in place for allocating the relatively cheaper domestic gas for catering to the CNG and the PNG (domestic) segments.

- ICRA believes that while PNGRB has rolled out this concept paper and invited comments from the public, the final regulation after incorporating the suggestions could vary significantly from what is being proposed. Moreover, the PNGRB Act, 2006 itself may require amendments in the light of the Supreme Court order dated July 1, 2015 in IGL Vs PNGRB case on the powers of the Board to fix tariffs. There is also a possibility that the existing players may challenge the final regulation in court, which could delay it further. Credit profiles of authorised entities would not be immediately impacted. Overall, ICRA believes that the step is indicative of the fact that the competitive landscape in the CGD business, where existing players have been enjoying a monopolistic position, could intensify over the medium to long term. However, operational challenges, such as determination of surplus capacity and access code will require resolution for actual materialisation of third party competition in the CGD business.

- Even if all the challenges are overcome and third party access is a reality, ICRA is of the view that profitability of the incumbents will not be affected materially in the old GAs, as the normative tariff determination process will ensure that a large part of the contribution from the sale of PNG and CNG will be retained by the incumbents through tariff. They will lose only the commodity margins. As a result, the credit profiles of the incumbents may not undergo a material change on this account. However, the incumbents could face headwinds from other disruptors such as electric vehicles, which could gather momentum over the medium to long term. The impact of this on the credit profile will be a key monitorable over the long term.

Annexure I: An illustration indicating the impact of the regulation in case it is finalised with the Cost of Service methodology allowing normative returns

Figures in Rs crore	IGL	MGL
PBITDA in 2018-19	1257	885
Net Fixed Assets (Rs. crore) (A)	3355	2133
Operating Costs (Rs. crore)	1,111	506.36
Normative Working Capital (20 days of operating costs) (Rs. crore) (B)	15	7
Normative Capital Employed (Rs. crore) …(A)+(B)	**3370**	**2140**
Allowed return on Equity on pre-tax basis (PBIT) 30%	21%	21%
Allowed return on Debt on pre-tax basis (PBIT) 70%	11%	11%
Allowed return on Equity on pre-tax basis (PBIT) 30% (Rs. crore)	213	135
Allowed return on Debt on pre-tax basis (PBIT) 70% (Rs. crore)	259	165
Total Allowed Return (Rs. crore)	**473**	**300**
PBIT (Rs. crore)	**473**	**300**
Depreciation as per books in FY2019 (Rs. crore)	201	126
Derived PBDIT (Rs. crore)	**674**	**426**
% of PBDITA assured through network tariff design^	***54%***	***48%***
% of PBDITA through trading margin	***46%***	***52%***
Normative Contribution OR Normative PBDITA + Operating costs (Rs. Crore) (C)	1784	933
Actual Contribution (sales-gas cost) in FY2019 (Rs. crore) (D)	2368	1392
% of contribution assured through network tariff design (C)/(D)	***75%***	***67%***

Source: Company audited financial results, ICRA analysis

^assuming that opex for third party access will be similar to existing operations; it's however likely that actual opex is lower than this.

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