



## PNGRB Regulations

### Sector Update

The Petroleum and Natural Gas Regulatory Board (PNGRB) has announced regulations for City Gas Distribution (CGD) networks. The PNGRB has finalised the regulations based on the industry feedback received on the draft regulations that was circulated among the players in November 2007. The regulations are applicable to the entities currently operating CGD networks as well as to the players who have plans to build and operate CGD networks.

#### Selection criteria

The entities that plan to roll out a CGD network would have to meet the following criteria:

- Natural gas availability with the entity/ possible connectivity with the natural gas source.
- The entity has laid and built either a hydrocarbon or CGD pipeline network in the past of more than 300km.
- The entity along with a JV partner (having more than 11% stake in the JV) has laid and built either a hydrocarbon or CGD pipeline network in the past of more than 300km.
- The entity is operating a CGD network since the past one year.
- The entity along with a JV partner (having more than 11% stake in the JV) is operating a CGD network since the past one year.

#### Bidding criteria

The Regulator has assigned weightage to four different parameters based on which the authorisation would be given.

- Lowest of network tariff over the life of the asset (25 years from the date of authorisation) - 40%.
- Lowest compression charge for CNG over the life of the asset - 10%.
- Highest inch-km of steel pipeline proposed to be laid during the exclusivity period - 20%.
- Highest number of domestic customers proposed to be connected through PNG during the exclusivity period - 30%.

#### Exclusivity

Being a capital intensive business, the Regulator has allowed certain exclusivity for the entities operating CGD network or who wish to enter the CGD business viz.,

- Newer entities shall be allowed exclusivity for a period of five years from the date of authorisation by the Regulator
- For the existing entities:
  - Entities operating CGD network for more than three years shall be allowed exclusivity for three years from the date of issue of letter by the Regulator.
  - Entities operating CGD network for less than three years shall be allowed exclusivity for five years from the date of issue of letter by the Regulator.

#### Tariff determination

The network tariff and compression charge for CNG shall be calculated using 'Discounted Cash Flow' methodology, considering reasonable rate of return. The tariff shall be applicable for the economic life of the project, subject to periodic review.

- *Reasonable rate of return:* 14% post-tax rate of return on capital employed (RoCE) is fixed taking into account the rate of return on long-term risk-free government securities and the need to incentivise investments in the creation of CGD infrastructure. The pre-tax rate of return considering the current corporate tax rate (34%) works out to 21.2%. The rate shall remain fixed for the entire economic life of the project.

- *Return on Capital Employed (RoCE)* and compression charge for CNG: The reasonable rate of return shall be applied to the total capital employed in the CGD network, CGD stations and related facilities. The total capital employed shall be equal to the Gross Fixed Assets less accumulated Depreciation plus Normative Working Capital (equal to twenty days of operating cost excluding Depreciation).

- Gross fixed assets shall be equal to actual historical cost of acquisition (including cost of any replacement or improvement or modification) or normatively assessed by the board whichever is lower.
- Operating costs shall be computed for operation and maintenance of CGD network and compressor facilities, on an actual basis or based on a normative assessment by the Board.

- *Volume for determination of unit network tariff:* The volume used for network tariff determination is actual



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volume of gas transported through the network and actual volume of gas compressed as CNG.

- *Economic life:* The economic life of the project is considered as 25 years from the date of authorization.
- *Review of network tariff and compression charges:* Tariff review will be carried out normally in a period of five years or during the two tariff periods by the Board at its own discretion or at the entity's request.

#### Implications for existing players

Gujarat Gas and Indraprastha Gas are CGD players. The cap on the returns (RoCE) is expected to hamper the performance of these companies. Although, there is a cap on RoCE, the companies are free to charge gas marketing margins to their customers.

Gujarat Gas, which procures gas at market rates, is well placed in the CGD space and we believe the regulations will not impact its performance severely. Nevertheless, historical RoCEs (including gas marketing margins) have been in the range of 25-30%. We are currently reviewing the impact of the regulations on the company and will downgrade our current Target Price. The stock has been

battered on the bourses due to the recent supply (which were resolved with GAIL's 2.13mmscmd supplies) and Regulatory concerns. We believe the negatives are factored in the price. Hence, given the robust growth expected in the Retail segment, **we remain positive on Gujarat Gas.**

#### Exhibit 1: Historical ARoCE (%)

| Year           | Gujarat Gas | Indraprastha Gas |
|----------------|-------------|------------------|
| CY2003/ FY2004 | 28.6        | 39.4             |
| CY2004/ FY2005 | 31.8        | 36.3             |
| CY2005/ FY2006 | 26.3        | 38.5             |
| CY2006/ FY2007 | 21.2        | 42.1             |

*Source: Company, Angel Research, Note: CY-Gujarat Gas, FY-Indraprastha Gas*

We believe that the Regulations will adversely impact Indraprastha Gas as it is currently procuring gas at APM prices and enjoys higher RoCE. Although, we estimate IGL to clock double-digit growth in CNG and PNG volumes, the Regulations will hit the company's Operating Margins with a spiraling effect on Profitability. **Hence, we downgrade IGL to Neutral.**

**Analyst - Rohit Nagraj**