The Petroleum and Natural Gas Regulatory Board (PNGRB) on April 9, 2012 had issued an order with respect to the network tariffs and compression charges which can be levied by Indraprastha Gas Limited (IGL) from its consumers for sale of Compressed Natural Gas (CNG) and Piped Natural Gas (PNG). The regulator determined tariffs were significantly lower than those petitioned by the company at the time as shown in the table below:

<table>
<thead>
<tr>
<th></th>
<th>Network Tariff</th>
<th>Compression Charges for CNG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Submitted by IGL</td>
<td>Rs. 104.05/MMBTU</td>
<td>Rs. 6.66/kg</td>
</tr>
<tr>
<td>As determined by the PNGRB</td>
<td>Rs. 38.58/MMBTU</td>
<td>Rs. 2.75/kg</td>
</tr>
<tr>
<td>PNGRB tariff/charges lower by</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The Regulator had ordered an immediate reduction in sales price of CNG and PNG by IGL based on the regulated rates indicated by it and had also instructed for the application of these tariffs retrospectively from April 1, 2008 implying that IGL would have had to refund the differential or excess tariffs charged from April 1, 2008 onwards. The differential was a staggering amount almost equivalent to the networth of the company at that point in time, and would have severely impacted the financial profile of IGL.

Following the order, the company had moved the Delhi High Court. In June 2012, the High Court pronounced its judgement on the matter in favour of IGL by ruling that the PNGRB does not have the powers to determine the network tariffs, compressions charges or in any other manner fix the maximum retail price to be charged by an asset owning marketer of gas like IGL from its customers and can only fix tariff for third party access. PNGRB thereafter appealed against the Delhi High Court order in the Supreme Court. The Apex court had subsequently sought a response from the GoI, and the latter in an affidavit filed in July 2013 stated that the regulator had no power to fix the maximum retail price at which the entities will market or sell notified petroleum and natural gas. While PNGRB conceded that it does not have the powers to regulate the final retailing price, it argued that it does have the powers as per the statute to fix the transmission tariff. The judgement of the Supreme Court had been awaited by incumbents in the CGD sector for the last two years as it had a direct bearing on their investment decisions. In the order passed yesterday, the Supreme Court has rejected the appeal of PNGRB against the Delhi High Court decision. This implies that asset owning Indian CGD players will have the freedom to fix their CNG and PNG prices, which includes transmission and compression charges for captive use.

The litigation between IGL and PNGRB had heightened the regulatory risk in the sector. It implied that the network tariff and compression charges have to be approved by the regulator based on the tariff petitions by the
concerned CGD entity, which should, amongst others, include multi-year forecasts of cash flows (until the end of balance license period). This had the potential of the approved network tariff and compression charges being at variance with those petitioned by the CGD companies depending on the assumptions used for variables like capex, volumes, capacity utilisation etc. However, with the Supreme Court's verdict, the regulatory powers of the PNGRB with respect to fixing of network tariff and compression charges for its direct consumers stands clarified, and this will have far reaching implications for the CGD sector.

The judgement allows the CGD industry incumbents greater freedom to fix the various components like network tariff, compression charges and the final price of CNG and PNG for consumers. As there are several components of pricing such as domestic natural gas prices, imported RLNG prices, forex rates which can be volatile and are outside the control of CGD entities, the ability to effect prices changes and freely price the gas to customers is crucial for the incumbents to achieve healthy returns, especially considering that the business involves huge upfront and thereafter continuing capex as well as long gestation periods as sales volumes typically build up slowly. It needs to be highlighted that the CGD industry is grappling with issues such as slow pace of regulatory approvals for opening outlets/laying pipelines, slow scale up in volumes, high imported gas prices, diminished competitiveness of PNG against industrial fuels with the recent fall in oil prices, poor returns in the PNG (domestic) segment etc. The reduced regulatory uncertainty is therefore a positive for the players and in ICRA's opinion is a credit positive for the incumbent CGD operators. While the regulator will continue to fix the network tariffs and compression charges for third party access, which could potentially put pressure on profits of incumbents if the approved rates are lower than petitioned rates, ICRA believes competition from third party marketers will be limited in the foreseeable future because of evolving nature of regulations for third party access, lack of access to cost competitive gas and significant deficit in the availability of domestic gas.

Also, ICRA believes the Supreme Court verdict will provide an impetus to the bidding for new districts that is being undertaken by PNGRB, which has laid out an aggressive target for CGD coverage on a pan India basis in the coming decade. While the inherent concerns of the business would remain, nevertheless an improved regulatory scenario leading to better pricing power eliminates uncertainty and improves the attractiveness of the sector.

On the flip side, with higher priority allocated for supply of cheaper domestic gas to CNG and PNG (domestic) sector by GoI, the sector could see heightened competition to win bids in the forthcoming rounds. As most players have quoted near zero tariff in the recent rounds for key cities, the winner was selected based on highest bid bond/performance bank guarantee quoted, the same was also high, at several times the networth of the entities. Such a strategy could elevate the business risk of bid winners, if they were to slip up on meeting the minimum work programme (on pipeline laying and PNG-domestic connections) stipulated by PNGRB for each city, as the regulator can encash the bank guarantee. Moreover, competition from third party marketers can emanate over the longer term when domestic gas availability improves and regulations reach a mature stage, as the bid tariffs will be applicable for the entire license period of 25 years. Hence a prudent approach while bidding, in light of other business uncertainties that will continue to impact the sector, could be a key success factor in this industry over the longer term.

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ICRA Limited

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon 122 002
Tel: +91 124 4545300 Fax: +91 124 4545350
Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE
1105, Kailash Building, 11th Floor, 26 Kasturba Gandhi Marg, New Delhi 110001
Tel: +91 11 23357940-50 Fax: +91 11 23357014

Branches: Mumbai: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 o Chennai: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 o Kolkata: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 o Bangalore: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 o Ahmedabad: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 o Hyderabad: Tel +(91 40) 2373 5061/7521, Fax + (91 40) 2373 5152 o Pune: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231

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