Indian City Gas Distribution sector

PNGRB's revised regulation for CGD authorization is a positive and should elicit more investor interest in the sector

April 2018

Contacts

K. Ravichandran
+91 44 4596 4301
ravichandran@icraindia.com

Ankit Patel
+91 79 4027 1509
ankit.patel@icraindia.com

Prashant Vasisht
+91 124 4545 322
prashant.vasisht@icraindia.com

Anoop Bhatia
+91 124 4545 315
anoopb@icraindia.com

Summary Opinion

- On April 3, 2018, PNGRB notified an amended regulation superseding the 2008 regulations for granting authorization to entities bidding to lay, build, operate or expand City Gas Distribution (CGD) networks. The need for changes in the regulation emanated from the in-effectiveness of the erstwhile bidding criteria to 1) Adequately reflect the relation between economic result of the operator and tariff quoted, as the income of the operator arises from marketing margin charged to consumers and not on tariff quoted, 2) Create an environment for healthy competition based on bid parameters, wherein both small and large players can compete on an equal footing, 3) Provide adequate incentive to bidders in terms of marketing exclusivity and 4) Mobilise highest possible investment in network creation by authorized entities . Further, the extant regulation did not provide adequate protection to authorised entities to receive extension of exclusivity period in case of delays attributable to externalities, which increased the project risks for interested players. At the same time, the erstwhile regulations also did not provide adequately for enabling the PNGRB to levy penalties for non-achievement of execution targets on an annual basis or for non-maintenance of continuous gas supply, which needed to be addressed.

- The new amended regulation has addressed most of the concerns stated above. The bidding criteria has been revised such that 80% weightage (compared to 0% earlier) is allotted to infrastructure creation so that gas network penetration is maximised while at the same time, participation of more players is incentivised with the extension of marketing exclusivity period for authorized entities to eight years (extendable upto ten years) as compared to five years earlier. This change should push the bidding entities to commit the highest resources to reach the highest number of consumers, which has been a key thrust area of the government.

- The new regulation also provides adequate checks by way of prescribed Minimum Work Programme (MWP) targets for each year for all three measurable segments – Steel pipeline length, CNG stations and domestic connections. In case of under-achievement, there are penalties for each year. Further, the new regulation provides for adequate pre-defined penalties to be imposed on the authorized entities in case of interruption in gas supply to consumers and adherence to other service quality standards. Thus, the regulation allows for a higher incentive, but also provides clearly for penalties if adequate efforts to meet the commitments are not made by the bid winners, which is a positive for development of the CGD sector over the long term. Overall, ICRA believes that the proposed changes in PNGRB regulations for bidding are forward looking and should attract more investor interest while at the same time protecting the long-term interests of the consumers.

Background: Evolution of bidding criteria for CGD auctions

According to PNGRB Regulations 2008, award of CGD networks for new geographical areas (GA) has to be done through a competitive bidding process, under which along with technical and financial parameters, the bidders would also be evaluated against a set of criteria. Between 2009 and 2018, PNGRB has conducted 8 bid rounds during which the bidding criteria has undergone some changes as discussed below:

Table 1: Bidding Criteria applicable for Bid-Round 1 to Bid-Round 3

Parameters	Weightage
Lowness of the present value of the overall unit network tariff (Rs./MMBTU) over the economic life of the network project (25 years)	40%
Lowness of the present value of the compression charge (Rs./kg) for dispensing CNG at the CNG stations over the economic life of the network project (25 years)	10%
Highness of the present value of the inch-kilometre of steel pipelines during the period of marketing exclusivity	20%
Highness of the present value of the number of domestic consumers proposed to be connected by PNG during the period of marketing exclusivity	30%

Companies which quoted highest composite score were declared winners. It may be noted that network tariff and compression tariff bid are applicable only for third party marketers who may want to use the incumbents' network on a common carrier basis after marketing exclusivity period (5years for new GAs). For incumbents, who use their captive network for selling CNG and PNG, above bid tariffs had only an academic interest, as the retail pricing of CNG and PNG are not regulated by PNGRB and the retail prices will subsume network tariff and compression charges.

For the 3rd round, submission of a feasibility report (FR) was stipulated along with bids, as bidders were quoting high numbers of PNG-domestic connections in the 1st and 2nd rounds, with near zero tariff bidding. There was also a stipulation that variations between the figures in FR and actual figures quoted should not be more than +/- 20%. Despite these changes, several bids continued to be aggressive (low capex, opex, high gas demand, high inch km of pipelines, domestic connections etc).

In order to ensure more rational bids, the regulator made further changes in the bidding criteria from September 2013 and is as listed below:

Table 2: Bidding Criteria applicable Bid-Round 4 onwards upto Bid-Round 8

Parameters	Weightage
Lowness of the present value of the overall unit network tariff (Rs./MMBTU) over the economic life of the network project (25 years)	70%
Lowness of the present value of the compression charge (Rs./kg) for dispensing CNG at the CNG stations over the economic life of the network project (25 years)	30%

While the FR was dispensed with, the modified norm specified limits on annual variation of the network tariff and compression charges which was to ensure more rational bidding from participants. Additionally, the last two points of the criteria that was specified earlier were substituted by a minimum work programme for PNG domestic connections and inch kilometre of steel pipelines to be laid by the successful bidder. The rationale for this substitution was to ensure mandatory compliance to achieve adequate coverage of the GA and population so that the benefits of gas supply reach the largest number of people.

In case of a tie in tariff bid by players, the winner is selected based on the value of bid bond submitted. Once the company which submits the highest bid bond wins the bid, as per guidelines, it has to submit a performance guarantee valid for five years equivalent to four times the value of the bid bond (which has to be renewed every five years till the end of authorisation period which is 25 years). As a result of the higher competition for some GAs, the performance guarantees required to be submitted were significantly high (as high as Rs 40-50 billion). Furthermore, in almost all the bids after Bid-Round 4, the network tariff and compression charge were quoted at the lowest possible value (1 paisa per MMBTU or Kg) by all participants and the winners were selected based on the highness of the bid bond submitted, which crowded out small and medium sized companies as the larger Oil & Gas companies with deep pockets were able to secure bank guarantees at a nominal cost. While the aggressive bids had their own reasoning for near zero tariff bids, the bidding process was increasingly being seen as unjust to smaller players and not conducive for sustainable growth of the industry over the long term.

As the bidding process was riddled with several infirmities, in August 2016, the MoPNG constituted a committee to recommend the alternate models on bidding criteria to grant authorization for CGD network in the country. The committee report was submitted on September 1, 2017. PNGRB had invited comments from any person or entity on the committee's report by November 20, 2017.

In January 2018, PNGRB released a draft regulation for CGD Authorization and in April 2018, the PNGRB has notified the amended regulations – "Authorising Entities to Lay, Build, Operate or Expand City or Local Natural Gas Distribution Networks - Amendment Regulations, 2018". The below table highlights the key changes in the regulation and ICRA's view on the impact of the changes.

Table 3: Key changes in the regulations and ICRA's view

Earlier provision	New Regulation	ICRA's view
(i)Financial Eligibility		
Minimum net worth for qualification ranges from Rs 0.05 billion (0.1 million population) to Rs 1.5 billion (5 million population). Proportionately higher after.	Ranges from Rs 0.5 billion (for GA with 0.1 million population and lower) to Rs 1.5 billion (for GA with 5 million population). Over 5 million population, Rs 0.3 billion for every 1 million	This is to ensure that only serious and financially stronger bidders participate, who meet the financial requirement of setting up and handling a CGD project.
(ii) Bidding criteria		
a) Lowness of the present value (PV) of the overall unit network tariff for the CGD network (70% weightage) b) Lowness of the present value(PV) of the overall unit compression charge for CNG for dispensing in the CNG stations (30% weightage) An Additional Bid Bond (ABB) was also to be submitted along with above bids. If a tie occurred, the higher ABB would decide the winner.	a) Lowness of the transportation rate for CGD*. Minimum bid rate is Rs 30/mmbtu* (10% weightage) b) Lowness of the transportation rate for CNG. Minimum bid rate is Rs 2/kg).* (10% weightage) c) Highness of Number of CNG Stations to be installed within 8 exclusivity (or contract) years (20% weightage) d) Highness of Number of domestic PNG connections to be achieved within 8 contract years (50% weightage) e) Highness of inch-km of pipeline to be laid within 8 contract years (10% weightage) <u>Year-wise %work set for first 8 years to achieve 100% of bid target</u> **Escalation in subsequent years considering quoted rate and WPI* *Bid bond and Performance bond to be submitted.*	The new bidding criteria shall ensure that the focus is on expanding the PNG pipeline and CNG network (50%+20%+10%=80%). Floor rates for the transportation rates will prevent un-reasonable bidding of low rates. WPI linking of the transportation rates reduces complexity of the bid. ICRA believes that significant high weight (50%) for PNG connections, reflecting the thrust of the GoI on this segment, would lead to significant widening of domestic PNG network. However, as the volumes from domestic PNG segment per inch km of pipelines laid remains lower than those for CNG or PNG (industrial/commercial), the profitability of the new entrants would have to be largely supported by marketing margins from other segments.

Earlier provision	New Regulation	ICRA's view
(iii) Performance bond		
Additional bid bond (ABB) equivalent to 4 times of bid bond as a PBG which could be forfeited in case of not meeting with MWP. Same is returned upon completion of MWP/end of marketing exclusivity.	Performance bond linked to population – Rs 0.5 billion for 5+ million population, Rs 15 million for less than 0.1 million population; Valid for 3 years initially; to be renewed for 3 more years and so on; PBG to be reduced to 40% of initial value after successful completion of work programme; Penalty by encashment in case of under achievement followed by replenishment of PBG	Rs 0.5 billion (or lower) is a low. Could lead to aggressive bids.
(iv) Bid bond		
Would be forfeited if company defaults to accept the grant of authorization	Would be forfeited in case of default to accept the grant of authorization. Further, there will be debarment for a period of three years from any bid thereafter (either by the entity/ associate/ holding/ subsidiary or in a JV)	The change will ensure that only serious and able parties participate in the bidding. Defaulters to be stopped from bidding in 3 future year rounds.
(v) Exclusivity period and Incentive		
5 years marketing exclusivity period from date of authorization	8 Years; Can be increased by 2 yrs if bid target for each of the eight years is achieved successfully. Can be increased by 1 year if overall bid target achieved.	Longer exclusivity will ensure that a player enjoys monopoly where it has invested a significant amount, especially, where the ramp up in volumes could take longer. Should increase participation as intended and would be positive for the sector.
(vi) Grant of authorization conditions		
a) Gas tie-up (not exceeding 180 days) b) Financial closure (not exceeding 180 days)	a) Gas tie-up for at least MWP requirement for 5 years (within 180 days) b) Financial closure for >90% of 8 year project cost (within 270 days) c) Pipeline entity to provide connectivity/access (within 180 or 270 days depending on availability of Sectionalizing Valve station).	Higher time is given for meeting the gas-tie up and financial closure to give adequate opportunity to the project entity.
(vii) Access to third party		
Network exclusivity for the first 25 years	25 years from authorization; After marketing exclusivity period, access to third party to be provided within 90 days of request.	No significant changes in this parameter.

Earlier provision	New Regulation	ICRA's view
(viii) Exit Options		
Not specified.	100% equity sale permitted after the end of the five years or achievement of quoted Work Programme, whichever is earlier. Transfer upto 50% equity sale permitted during first five years subject to lead partner maintaining highest stake.	Clarity provided on exit options for bidders. Allows companies who are unable to generate adequate returns to exit by selling to other players. Reduces overall business risk for new entrants.

Stringent penalties to be imposed or default on MWP

Table 4: Minimum Work Programme

By the end of contract year	PNG Connections (cumulative)	CNG Stations (cumulative)	Inch-km of steel pipeline (cumulative)
	% of work programme		
1	0	0	5%
2	10%	15%	20%
3	20%	30%	40%
4	30%	45%	60%
5	40%	60%	70%
6	60%	75%	80%
7	80%	90%	90%
8	100%	100%	100%

The erstwhile regulations imposed the MWP only for the total number of domestic connections and the total pipeline to be laid, whereas the new regulations have also incorporated the number of CNG stations into the MWP. Also, the erstwhile regulations were unclear on the time frame of levy of penalty and resulted in significant delays in determination of the exact quantum of penalties to be levied from the authorized entity. However, the new regulation has specified penalties that can be levied each year. A pre-determined penalty shall be levied and recovered from the entity within three months from the end of each contract year in respect of any shortfall in achieving cumulative work programme targets for that contract year computed at the rates specified below without any notice. Only in the case of a force majeure situation duly accepted by the PNGRB, the pre-determined penalty may be waived or reduced.

Table 5: Penalties for under-achievement of Minimum Work Programme

	PNG connections (per connection)	CNG station (per station)	Steel Pipeline (per inch-km)
Shortfall penalty	Rs 750	Rs 20 lakhs	Rs 1.5 lakhs

More importantly, any penalty levied shall initially be recovered by encashment of the performance bond. The entity shall be required to make good the performance bond to its full value within thirty days of encashment. If the entity fails to make good the performance bond within such period, the Board shall encash the remaining amount of the performance bond and may also terminate the authorisation. Thus, it makes it very clear that non-adherence to the MWP would mean immediate impact on the financials of the CGD entity. This will further aid in ensuring strong commitment to completion of the project in a timely manner.

An illustration: For an authorized entity that has committed to connect 1 lakh PNG connections, 15 CNG stations and 2000 inch-km steel pipeline to win the bid, the maximum penalty that could be imposed each year on the entity (if there is 0% achievement on all parameters) is calculated for the first five years as below.:

Table 6: Illustration for possible penalties for under-achievement of Minimum Work Programme

Maximum Penalty for non achievement of MWP	PNG Connections	Natural Gas Stations	Inch-km of steel pipeline	Total
Target committed (Nos)	**100000**	**15**	**2000**	
Penalty rate	Rs 750/connection	Rs 20 lakhs/station	Rs 1.5 lakhs/inch-km	
Year 1 (Rs crore)	0.00	0.00	1.50	**1.50**
Year 2 (Rs crore)	0.75	0.45	6.00	**7.20**
Year 3 (Rs crore)	1.50	0.90	12.00	**14.40**
Year 4 (Rs crore)	2.25	1.35	18.00	**21.60**
Year 5 (Rs crore)	3.00	1.80	21.00	**25.80**

Penalties for non-adherence to service standards for consumers

The PNGRB had always specified that authorized entities are to maintain stringent service quality and standards so that all necessary steps are taken to ensure that consumers are not affected. However, the erstwhile regulations did not mention any method of penalty on the CGD entity for non-adherence. As per the new condition for authorization, the entity shall maintain an uninterrupted supply of natural gas to all categories of customers in the CGD network. In the event of any disruption in the supply of natural gas in the CGD Network, first priority shall be accorded to restoration of supplies to domestic PNG customers. In case of disruption of supply to domestic PNG customers for more than twelve hours, the entity shall compensate the domestic customer at ten times the average daily consumption of the last three months for each day's disruption. This will be done through a credit to the domestic PNG consumer in the next billing cycle.

Appropriate timing of the new regulation with mega bid round 9 around the corner

In February 2018, PNGRB has announced a mega Bid Round 9 in which it has invited bids from participants for a total of 86 GAs. This is by far the highest in history of PNGRB and higher than all earlier rounds combined if the total number of districts that are on offer is considered. Within the 86 GAs, a total of over 180 different districts are on offer. PNGRB has changed its approach in treating GAs as districts and combined multiple adjoining districts as part of one GA. ICRA believes that this will allow bidders to consider the economies of scale of investing in a larger area without worrying about the possibility of competing with another player in its immediate neighborhood. This approach is also favorable for PNGRB, as it shall not have to monitor the progress separately for a large number of districts in the same region from a multiple set of entities. The mega offering of GAs is in conformation with the GoIs plan to increase the penetration of natural gas as fuel for consumers.

The successful completion of the Bid Round 9 with authorization to all the planned GAs would mean that the CGD sector would see a significant increase in investments over the next 8-10 year period. And thus, the timing of the new regulations just in time for the commencement of bidding for bid round 9 is appropriate.

Conclusion

With 80% weightage given to higher infrastructure and the commitment laid out in quantity instead of the earlier criteria of network tariff and compression charges, the new regulations clearly shifted the focus to higher network penetration. At the same time, there is a clear attempt to incentivize the serious players and penalize the under-achievers. Further, various minor tweaks to the criteria have also simplified the overall bid complexity – for eg. WPI linking of transportation rate for all years after the first year. Further, the provision of complete exit option after 5 years is favorable for bidders as it reduces long term business risk. Overall, ICRA believes that the proposed changes in PNGRB regulations for bidding are forward looking and should attract more investor interest while at the same time protecting the long-term interests of the consumers.

ICRA Contact Details

CORPORATE OFFICE
Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon 122002
Ph: +91-124-4545300, 4545800
Fax; +91-124-4545350

REGISTERED OFFICE
1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi – 110 001
Tel: +91-11-23357940-50
Fax: +91-11-23357014

CHENNAI
Mr. Jayanta Chatterjee
Mobile: 9845022459
5th Floor, Karumuttu Centre,
498 Anna Salai, Nandanam,
Chennai-600035.
Tel: +91-44-45964300,
24340043/9659/8080
Fax:91-44-24343663
E-mail: jayantac@icraindia.com

HYDERABAD
Mr. M.S.K. Aditya
Mobile: 9963253777
301, CONCOURSE, 3rd Floor,
No. 7-1-58, Ameerpet,
Hyderabad 500 016.
Tel: +91-40-23735061, 23737251
Fax: +91-40- 2373 5152
E-mail: adityamsk@icraindia.com

MUMBAI
Mr. L. Shivakumar
Mobile: 9821086490
3rd Floor, Electric Mansion,
Appasaheb Marathe Marg, Prabhadevi,
Mumbai - 400 025
Ph : +91-22-30470000,
24331046/53/62/74/86/87
Fax : +91-22-2433 1390
E-mail: shivakumar@icraindia.com

KOLKATA
Ms. Vinita Baid
Mobile: 9007884229
A-10 & 11, 3rd Floor, FMC Fortuna,
234/ 3A, A.J.C. Bose Road,
Kolkata-700020.
Tel: +91-33-22876617/ 8839,
22800008, 22831411
Fax: +91-33-2287 0728
E-mail: Vinita.baid@icraindia.com

PUNE
Mr. L. Shivakumar
Mobile: 9821086490
5A, 5th Floor, Symphony,
S. No. 210, CTS 3202,
Range Hills Road, Shivajinagar,
Pune-411 020
Tel : +91- 20- 25561194,
25560195/196,
Fax : +91- 20- 2553 9231
E-mail: shivakumar@icraindia.com

GURGAON
MR. Soumitra Sarkar
Mobile: 9582335927
Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,

AHMEDABAD
Mr. Animesh Bhabhalia
Mobile: 9824029432
907 & 908 Sakar -II, Ellisbridge,
Ahmedabad- 380006

BANGALORE
Mr. Jayanta Chatterjee
Mobile: 9845022459
'The Millenia', Tower B,
Unit No. 1004, 10th Floor,

Gurgaon 122002 Ph: +91-124-4545300, 4545800 Fax; +91-124-4545350 E-mail: soumitra.sarkar@icraindia.com	Tel: +91-79-26585049/2008/5494, Fax:+91-79- 2648 4924 E-mail: animesh@icraindia.com	Level 2, 12-14, 1 & 2, Murphy Road, Bangalore - 560 008 Tel: +91-80-43326400, Fax: +91-80-43326409 E-mail: jayantac@icraindia.com

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 **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 **Kolkata**: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune**: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231