India hikes Gas Prices to $8.4/mmbtu for five years from April 01, 2014.

Finally the convergence between economics and politics play out and India is able to hike output gas prices to $8.4/mmbtu from $4.2/m mbtu for five years commencing from April 01,2014.to induce more capital investments in the domestic Exploration & Production (E&P) space. The cabinet has given their nod to the formula developed by the C. Rangarajan committee with a minimal adjustment of removing the spot prices factor out of the formula. It looks pretty evident from the Oil Minister & Finance Minister's verbal interaction with the media that their prime focus is to ramp up the investment cycle in the domestic E&P space both from the domestic as well as from the overseas investors.

The rationale behind this hike in gas prices to ramp up the gas production by way of attracting more investments which ultimately lower the import of gas that in turn facilitate to curb down the high Current Account Deficit (CAD).

This new gas pricing policy will applicable only to the new contracts and not on the existing contracts subject to conditionality. Moreover the gas price will be reviewed on quarterly basis.

The Ministry officials stated that this gas price hike is only to gas producers only and not to those who use gas as an input material. The GoI also mentioned the gas price is still below the international rates even after the hike which happened after three years owing to the stiff resistance from the fertilizer and the power ministries'.

The input price of the gas will be decided in due course of time and more clarity will come up as the time passes.

The government rationalizes it's move by citing the dire condition through which India is going right now both in terms of dipping domestic production coupled with falling investment in the oil & gas space. The production has dipped to ~111.40mmscmd in 2012-13 from ~143 mmscmd in 2010-2011. The domestic production from the PSU players is stagnated at ~70mmscmd whereas production from the private players has plummeted to ~40mmscmd from ~73mmscmd for the period ranging from 2010-11 to 2021-13. The investment cycle in 2011-12 has also trimmed to $1.8bn from $6.3bn in 2008-09. The increasing demand for gas will lead to more import unless the issue is somewhat addressed by ramping up the domestic production which can only be done by bringing investment as felt by the GoI.

Our View

Broadly this step will bring some sentimental boost for all the market participants as it could be perceived as the government's intent to carry out the proposed reformatory steps ahead and this move will definitely compliment the vision. This step will uplift the segment as a whole of which ONGC, OIL & Reliance Industries (RIL) seem to be the biggest beneficiaries. Apparently ONGC & Oil India Ltd. is being preferred in this space but it is not all rosy for these companies. We all know that the GoI has a share in the profits of these companies which means the incremental profit is likely get back into the governments' hands by way of higher royalty, corporate tax and dividend from the investments. Around ~65% of the ONGC's realization goes to the Central Government and State Government treasury in the proportion of 50% & 15% respectively. The management stated that for every $1 hike in gas price would result to an increase of INR8500crores in the bottomline ceteris

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Paribas. For Oil India every $1 hike in gas price will lead to around incremental revenue of INR 400crores and INR200 crores in the bottomline but the subsidy sharing mechanism is still an overhang for the public upstream companies. A back of the envelope calculation and the general consensus get us an upside of ~20%-25% for ONGC, 12%-15% for OIL, 2%-4% for RIL in the EPS ceteris Paribas respectively considering the longer term perspective. In regards to RIL the company can take advantage of this gas price hike only if they able to ramp up production from their oil & gas blocks otherwise this benefit of hike in gas price would be negated by the dipping output. Hence we believe this step is good enough to keep our positive view intact on the Oil & Gas sector as a whole. The hike in gas prices will enable the companies to monetize the financially unviable projects as well as to increase E&P activities which would add to their margins. We envisaged that the impact will only be seen not before 2015-16 at the least.

However GAIL India expected to face the heat on near term basis because of this hike in gas prices but their management opined that they are capable enough to create infrastructure by way of capex to boost their operational efficiency in the long –term. Moreover GAIL also received a waiver on the subsidy burden for H2FY14 and we envisage this trend may continue considering the fact GAIL does not gain from the surging of the global crude oil prices.

Whilst exempting GAIL from the subsidy sharing mechanism may resultant in the increased subsidy sharing burden for the ONGC and OIL which is also a matter of concern.

The Indian cabinet committee on economic affairs (CCEA) allows the end of existing administered pricing mechanism (APM) to align gas price at market determined rates for Reliance Industries Limited (RIL) from April 2014 onwards. Under the new regime the output price of natural gas may rise to $8.4/mmbtu from the current $4.2/mmbtu as per the formula suggested by the C, Rangarajan panel.

The CCEA allowed RIL to increase its gas prices from April 01, 2014 onwards in lieu of bank guarantees and that the guarantee only will be encashed if RIL are found guilty of hoarding gas or deliberately suppressing the production from the KG-D6 block. Earlier the GoI slapped a penalty of ~$1.8bn for missing the proposed production of the aforesaid block.

This move proves beneficial for RIL only in the long-term. As their current production is almost at the lowest levels and only the revival in the dipping production coupled with this increased price hike can bring cheers to the books. RIL mentioned in their AGM they are taking all the necessary measures to revive their entire oil & gas portfolio which is positive sign for the company itself. Their current production was dipping to ~10mmscmd from the peak~ 60mmscmd. For the Indian oil & gas sector as a whole it is pretty positive as the increase in the gas prices would result in the viability of some projects by way of better realizations.

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On the contrary the power and the fertilizer industries are going to hit majorly with the gas price hike and no clarity has been furnished yet from the GoI end on how they are thinking of tacking the issue of rise in input costs.

The GoI also allowed Coal India to produce Coal Bed Methane (CBM). As per the DGH India has a CBM reserve of 4.6 trillion cu. m. of which India's current CBM production is 0.15mscmd and expected to rise to 7.4mscmd in some time.

C. Rangarajan Committee recommended some amendment in the existing Production Sharing Contract (PSC) to revive the Indian Oil & Gas sector. The implementation of proposed reforms is expected to induce more investments in the Indian oil & gas sector. The committee use the netbacks price (i.e. net off transportation costs, liquefaction costs etc.) to make it off the variables which enables to get a more fair price. The recommendation norms is designed to simplify the process which in turn pace up the E&P activities although the recommended norms will only be applicable on the future blocks i.e. blocks to be awarded under NELP 10 auction. The proposed norms will bring more revenue to the government exchequer with the hike in oil & gas price and production.

<u>An Indicative depiction of the new gas pricing formula</u>

New Gas Pricing Formula			
Contracts	Volume	FoB Price	Netback Price
Unit	mmtpa	USD/mmbtu	USD/mmbtu
Long -Term contracts	9.5	9.5	7.20
Shell Imports	2.53	14	12.2
Total Imports	12.03		
Volume weighted prices of LNG import-(1)			9.4
Gas Benchmark	FY12Avg. Price(US$/mmbtu)	FY12 volume (bcf)	
Henry Hub	3.61	83.6	
NBP(UK)	10	106.5	
Netback price for Japan	12	10.2	
Weighted Average Price-(2)		7.43	
Recommended Gas Price (average of 1 & 2)			8.40

Indicative Table.Source:C.Rangarajan report,Bloomberg,microsec Research

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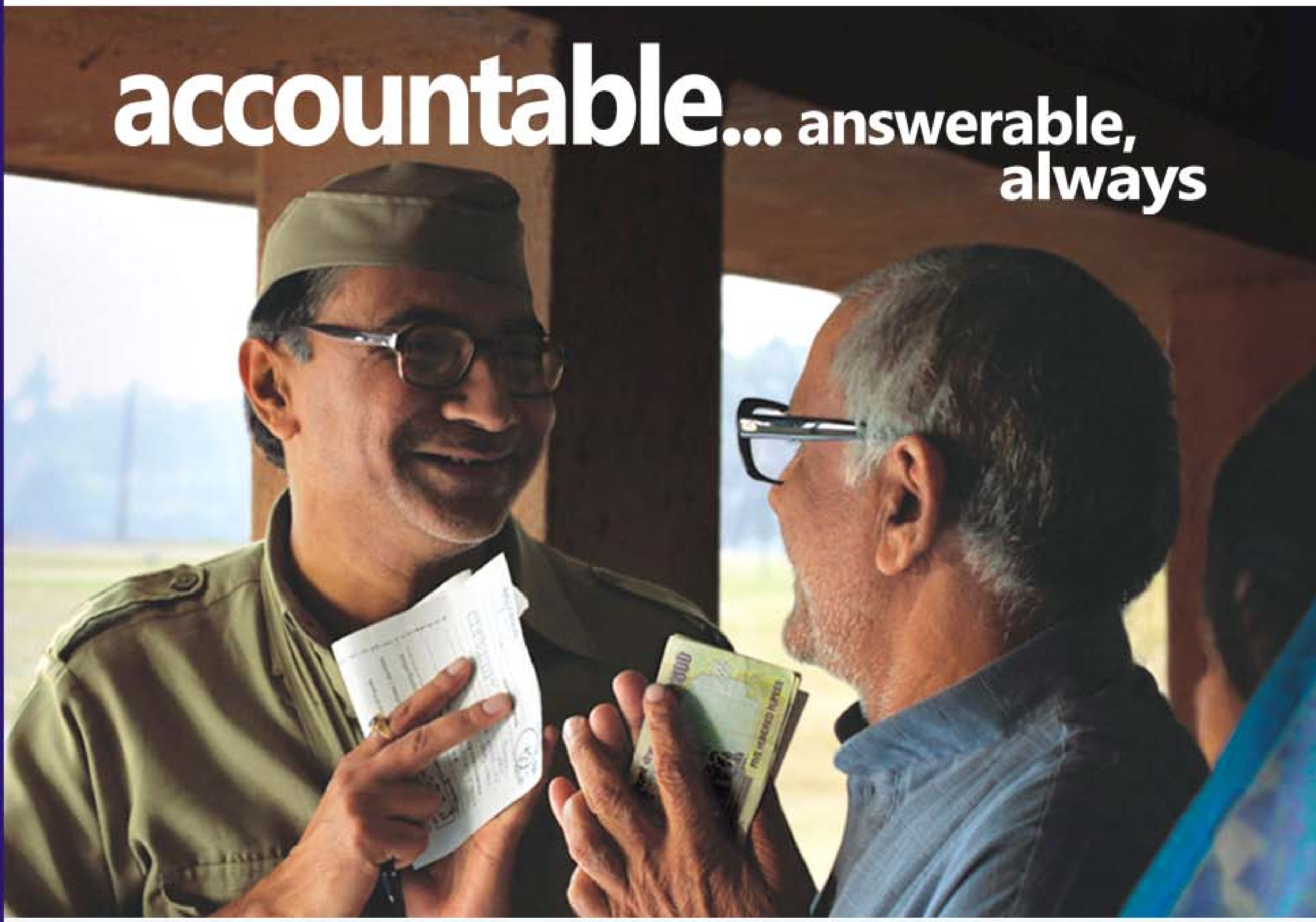

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