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INDUSTRY QUICK COMMENT

Similar to pipeline bids last year, ultra-low zone-1 tariff bid strategy has again prevailed. This time GAIL used it and won the Surat-Paradip pipeline. Last year, GSPL's JV had cornered all three pipelines, using this strategy. Bidding may seem irrational, but bidding criteria were also irrational, in our view. Bidders took advantage of loopholes (see exhibit 1-3). Despite low zone-1 tariff, pipeline may still make decent returns, as tariffs sharply increase in other zones. But, more than returns, priority seems to have been on cornering pipelines first and worrying about tariffs later.

Research analyst: Anil Sharma | +91 22 4037 4338 | anil.sharma.1@nomura.com

Research analyst: Ravi Adukia, CFA | +91 22 4037 4232 | ravikumar.adukia@nomura.com

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India Gas: Irrational tariff bidding continues – This time GAIL adopts and emerges winner

GAIL wins Surat-Paradip pipeline, with low zone-1 tariff: Very similar to ultra-low tariff strategy adopted by GSPL's JV (GSPL 52%) last year, GAIL seems to have followed suit and has emerged a winner. As per an Economic Times article (GAIL wins rights to lay Surat-Paradip pipeline, 16 Nov 2011), GAIL bid very low (in fact the lowest allowed) tariff of 1 paisa/mmbtu in zone-1.

Bidding criteria encouraged irrational bidding: Such ultra-low zone-1 tariff may seem irrational, but perhaps was warranted as bidding criteria was somewhat irrational and too mathematical, in our view. As we highlighted in our note after GSPL won pipelines last year (Cross-country pipeline bidding – adding to the chaos, 22 October 2010) and in our anchor report (India Gas – Time to get back in), the bidding criteria were highly mathematical. It required bidders to give projections for each of the next 25 years, and gave too much weight to just zone-1 tariff.

Winners could still make decent returns: We had also highlighted (using hypothetical numbers) that despite low tariff zone-1 tariff, winners could charge high tariffs from zone -2 onwards so that average tariffs remain high and returns are reasonable. Despite low zone-1 tariffs for its three pipelines, GSPL remains confident of achieving 15%+ IRR. GAIL may also get similar returns.

With actual bid numbers now available on PNGRB website, as an example we analyse the numbers bid by GSPL JV and GAIL for Mallavaram-Bhilwara/Vijaipur pipeline last year. This shows that though GSPL's JV bid for low tariffs in zone-1, tariffs sharply increased from zone-2 onwards. By bidding very low in criteria 1 (zone-1 tariff) and criteria 3 (zone 2 to 3 escalation), GSPL would have scored 100% score (and GAIL below 10%) for these two criteria. Thus despite getting lower score in criteria 2 and nearly same score in volume criteria 4, GSPL's JV would have emerged winner by a wide margin.

First priority seems to corner pipeline: The strategy of bidders (at least of winners) has been seemingly (and perhaps rightly so) to take advantage of loopholes and win networks first and worry about tariffs later.

The penalties, if pipelines are not constructed (or not constructed on time) are not high. The performance bond for three pipelines awarded last year ranges from INR150mn to INR200mn, and is less than 0.5% of estimated project cost for INR120bn for three pipelines put together.

Adds to near term concerns: Even as we consider that winning a pipeline is positive (we believe pipeline would be constructed only; companies would see these as NPV positive) in near term such low bids add to concern. The serious investment in these pipelines would be forthcoming, in our view, only when companies see clear visibility on demand on the route of these pipelines, and also supply visibility via domestic gas or imported LNG.

We highlight that not much work has commenced on the three pipelines that GSPL's JV won last year. After long delays, the actual authorization for these pipelines was issued by the regulator only in July 2011, and the six month period to achieve financial closure is valid till January 2012.

In fact, not much physical progress has taken place on several pipelines that were authorised by Ministry of Petroleum and Natural Gas in 2007 (prior to formal appointment of regulator in 2008).

We do not ascribe value to these pipelines yet: With limited clarity on gas demand/ supply, tie-ups with customers and realistic timelines, we currently do not ascribe any value either for three pipelines won by GSPL's JV or now for GAIL's Surat-Paradip pipeline. As we say earlier, if implemented, these pipelines would be value accretive, but till these projects are completed market's concern and over-hang would remain on tariff, volume, funding, execution etc.

We like both GAIL and GSPL, but concerns remain near term:

We like GAIL (Buy, PT INR565) and see it as a good defensive. Even as near term concerns remain on low gas volume growth, GAIL would remain key beneficiary of medium to long term gas upsides. Subsidy sharing also remains a risk and over-hang, but GAIL remains least impacted among oil PSUs. Even as new pipeline win adds to near term concerns, we were surprised by stock's sharp reaction yesterday (was down 6% intra-day, and closed 4% lower) on concerns regarding low tariff bid. We would view such weakness as an opportunity to buy.

We continue to like GSPL (Buy, PT 135) as a long-term gas transmission pure play, but in the near term volumes growth is likely to remain muted, and we expect market concerns will also remain on tariff, new pipeline capex etc.

Exhibit 1: Bidding criteria for gas pipeline networks

	Bidding criterion	Weightage	Comments
1	Lowness of the PV* Zone - I tariff	40%	- Bid shall be for each year of the economic life. - Weightage of 70% if length of pipeline is <=300kms
2	Lowness of % increase in tariff from Zone 1 to 2	20%	- a single number to be bid (No max limit) - Zero weightage if pipeline is <=300kms. - 30% weightage if length between 300 to 600kms.
3	Lowness of % increase in tariff from zone 2 to 3	10%	- a single number (but it should be less than 100%)
4	Highness of the PV* of gas volumes (in mmscmd)	30%	- Volumes bid shall be for each year of the economic life.

* PV to be calculated using a discount rate of 12%

Source: PNGRB, Nomura Research

Exhibit 2: Key bidding details of Mallavaram-Bhilwara/Vijaipur pipeline

Year	1	2	3	4	5	10	15	20	25	NPV @ 12%
Bidding criteria										
Zone-1 tariff (INR/mmbtu)										
- GSPL	0.01	0.20	1.00	1.00	1.00	1.16	1.48	1.48	1.48	8.26
- GAIL	13.0	13.0	13.3	13.3	13.5	14.1	14.9	15.5	16.5	108.6
% increase in Zone 1 to 2 tariff										
- GSPL	3000%		Bid very low zone-1 tariff, but very high % increase to zone 2							
- GAIL	358%		High zone -1 tariff; yet sharp % increase to zone 2							
% increase in Zone 2 to 3 tariff										
- GSPL	1%		Very low % increase to zone 3							
- GAIL	45%									
Volumes (mmscmd)										
- GSPL	40	40	40	40	40	40	45	52	57	363
- GAIL	38	42	42	42	42	42	42	42	42	326
Calculated tariffs										
Zone 2 (INR/mmbtu)										
- GSPL	0.3	6.2	31.0	31.0	31.0	36.0	45.9	45.9	45.9	
- GAIL	59.5	59.5	60.7	60.7	61.9	64.4	68.3	71.1	75.4	
Zone 3 (INR/mmbtu)										
- GSPL	0.3	6.3	31.3	31.3	31.3	36.3	46.3	46.3	46.3	
- GAIL	80.4	80.4	82.0	82.0	83.6	87.0	92.4	96.1	102.0	

Source: PNGRB, Nomura Research

Exhibit 3: Likely bidding calculation

	Bidding Criteria	Weight	Bidders		Comments
			GSPL	GAIL	
1	PV of Tariff in zone 1 (INR/mmbtu)	**40%**	**8.26**	108.63	
2	% increase for Zone 1 to 2	20%	3000%	358%	
3	% increase for Zone 2 to 3	10%	1%	45%	
4	PV of gas volumes (mmscmd)	30%	362.85	325.66	
	Criteria scores (%)				
1	PV of Tariff in zone 1 (INR/mmbtu)		100	8	Best bidder gets 100 percent points - the other gets proportionate
2	% increase for Zone 1 to 2		12	100	
3	% increase for Zone 2 to 3		100	2	
4	PV of gas volumes (mmscmd)		100	90	
	Weighted scores				
1	PV of Tariff in zone 1 (INR/mmbtu)		40	3	GSPL would have got 100% score in three of 4 categories
2	% increase for Zone 1 to 2		2	20	
3	% increase for Zone 2 to 3		10	0	
4	PV of gas volumes (mmscmd)		30	27	
	Composite score		**82**	**50**	

Source: PNGRB, Nomura Research

Note: Ratings and Price Targets are as of the date of the most recently published report (http://go.nomuranow.com/research/globalresearchportal) rather than the date of this email.

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Mentioned companies

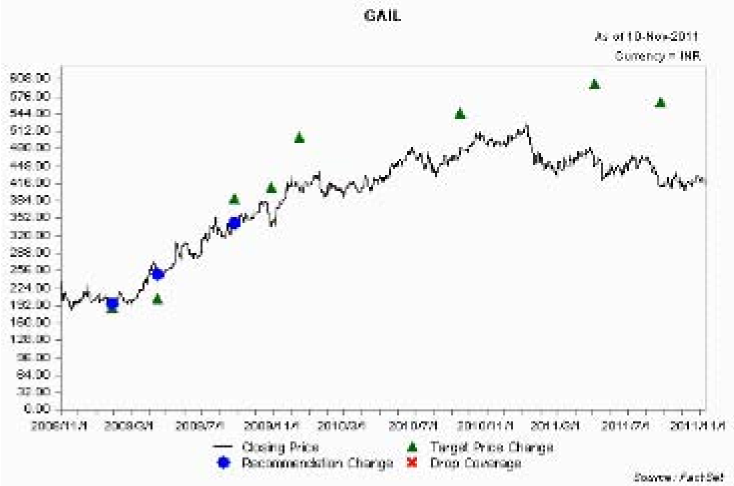
Issuer name	Ticker	Price	Price date	Stock rating	Disclosures
GAIL	GAIL IN	391.5 INR	16 Nov 2011	Buy	
Gujarat State Petronet	GUJS IN	95.6 INR	16 Nov 2011	Buy	

Previous Rating

Issuer name	Previous Rating	Date of change
GAIL	Reduce	27 Aug 2009
Gujarat State Petronet	Not Rated	11 May 2010

GAIL (GAIL IN) **391.5 INR (16 Nov 2011)** Buy

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
25-Aug-2011		565.00	413.40
05-May-2011		600.00	449.95
15-Sep-2010		545.00	483.30
16-Dec-2009		500.00	409.30
29-Oct-2009		410.00	343.05
27-Aug-2009		390.00	343.15
27-Aug-2009	Buy		343.15
16-Apr-2009		205.00	249.35
16-Apr-2009	Reduce		249.35
29-Jan-2009		190.00	196.80
29-Jan-2009	Neutral		196.80

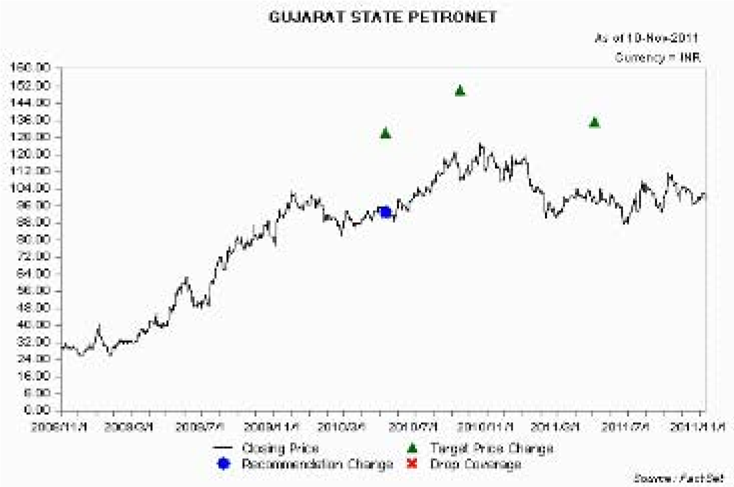
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We have used sum-of-the-parts as our primary tool to value GAIL's diversified business. We have valued its gas transmission business (including gas trading) at 10x its FY13F EBITDA. We have assigned a multiple of 7x FY13F EBITDA for petrochemical and 6x FY12F estimated EBITDA for the LPG business. We also value E&P upside at a conservative INR14/share. Our target price is INR565.

Risks that may impede the achievement of the target price Key downside risks: lower transmission volume growth, a sharp cut in overall tariffs by the regulator (we do not assume any cut), a sharper decline in polymer prices and higher subsidy burden than our assumption.

Gujarat State Petronet (GUJS IN) **95.6 INR (16 Nov 2011)** Buy

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
05-May-2011		135.00	98.85
15-Sep-2010		150.00	109.30
11-May-2010		130.00	93.35
11-May-2010	Buy		93.35

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use DCF methodology to value GSPL. We use a WACC of 10.4% and terminal growth rate of 2.5%. Our DCF-based target price is INR135.

Risks that may impede the achievement of the target price Key downside risks: Lower-than-expected growth in transmission volumes, a sharp cut in transmission tariffs by PNGRB post application of tariff regulations, and any actual social contribution as per the directive of the Gujarat Government (we do not factor any outgoing).

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009

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Nomura Financial Advisory and Securities (India) Private Limited, India Tel: +91 22 4037 4037

Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road,
Worli, Mumbai- 400 018, India Fax: +91 22 4037 4111