Gujarat State Petronet GSPT.NS GUJS IN

OIL & GAS/CHEMICALS

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Not harsh, but a poor tariff order

Quick Note

September 12, 2012

Rating Remains	**Buy**
Target price Remains	INR 85
Closing price September 11, 2012	INR 75

Tariff order not harsh, but would add to confusion

The Petroleum & Natural Gas Regulatory Board (PNGRB) has finally issued the "provisional initial unit" tariff order for Gujarat State Petronet (GSPL). On first look, compared to PNGRB's earlier tariff orders for other entities, the order appears soft. The determined tariff of **INR23.99/mmbtu (INR904/scm)** seems good for GSPL, in our view, and better than street expectations of INR750-850/scm. Even as the headline tariff indicates a tariff reduction, and payout for retroactive implementation, we think the actual payments may not be much, and GSPL's average reported tariff numbers may not decline much. But in the short term, there will be added confusion till clarity emerges on retroactive payments, and actual impact on GSPL's realised tariffs going forward.

Tariff 12% lower than current; but only 2% lower than past 5-year avg

The determined tariff of INR24/mmbtu includes 0.3% of System Use Gas (SUG), which was hitherto not charged, but taken in kind from customers. Adjusted for SUG, the determined tariff is:

- 12.5% lower than current average tariffs of INR27.4/mmbtu. Of this 6.5% is due to lower tariff and 6% due to disallowance of SUG.
- Only 2% lower than average tariff since FY09
- 5% higher than our avg LT tariff assumptions of INR800/mscm

Retroactive order applicable from 20 Nov 2008

GSPL's high pressure pipeline network was authorised recently in July 2012. Company had suggested tariff order either from April 2011 or April 2012. But, PNGRB has continued to insist on retroactive implementation effective 20 November 2008.

We highlight that each tariff order is applicable for five years. The current tariff order is a provisional tariff order with final tariff to be decided in a year's time. By the time PNGRB finalises the final tariff, the term of the current order (Nov 2013) may well lapse, in our view.

The insistence on having such a backdated tariff does not seem very logical to us. It will create a lot of confusion as to calculation of past costs and refunds etc, which would need to be worked out for each customer and each year separately. When overall tariff amounts are low (relative to gas costs) and not many complaints from customers that tariffs are high, we find it difficult to justify the need for such retroactive orders.

Outlays for past charges may not be high

As we highlight, the working out of past tariff and system usage charges, will be cumbersome and create confusion.

In our view, calculating outlays on the basis of the headline tariff cut and system use charges could be misleading and at max may indicate the upper range. This would imply total impact of:

- INR2.5bn for 6.5% cut in tariff.
- INR2.3bn for 6% impact due to SUG not being allowed

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

But, we highlight that as GUJS's determined tariff is only 2% lower than the average realised tariff for last 5 years. This would imply impact of only INR650mn for past periods.

The actual payment would be somewhere in that range but may not exceed INR1bn, in our view. This would imply an impact of INR1.20/ share or 14% for FY13F earnings for retroactive adjustments. We will await clarity from management as to the likely actual payment.

Fig. 1: Headline tariff 12.5% lower than existing tariff (including SUG)

	INR/mmbtu	INR/mscm
GSPL		
- Tariff submitted	39.55	1491
- Existing weighted avg. tariff	25.76	971
- Existing weighted avg. tariff incl SUG	27.41	1033
PNGRB		
- Tariff determined	23.99	904
Reduction from		
- Tariff submitted	-39.3%	-39.3%
- Existing weighted avg. tariff	-6.9%	-6.9%
- Existing weighted avg. tariff incl SUG	-12.5%	-12.5%

Source: PNGRB Tariff order, Nomura research

Fig. 2: Tariff only 2% lower than past five year average – payment may not be high

	FY09	FY10	FY11	FY12	1QFY13A	Avg.
Reported tariff						
- INR/mscm	898	850	789	866	894	859
- INR/mmbtu	23.8	22.5	20.9	23.0	23.7	22.8
Reported tariff adjusted for SUG						
- INR/mscm	960	912	851	928	956	922
- INR/mmbtu	25.5	24.2	22.6	24.6	25.4	24.4
Tariff determined by PNGRB						
- INR/mscm	904					
- INR/mmbtu	23.99					
Difference %						
- vs reported nos.	1%	6%	15%	4%	1%	5%
- vs nos. adjusted for SUG	-6%	-1%	6%	-3%	-5%	-2%

Source: Company data, PNGRB, Nomura research

Fig. 3: Tariff reconciliation – What GSPL asked and what it got

Volume, capex, unaccounted gas and manpower cost account for 95% of reduction

	INR/mmbtu	
Tariff submitted by GSPL	**39.55**	
Changes		
- Lower rate of inflation as 4.5%	0.43	3%
- Disallowance of unaccounted gas	1.60	10%
- Volume as per regulations	7.79	**50%**
- Capex only for approved pipelines	3.96	**25%**
- Pre-tax IRR considered at 18.18%	(1.34)	-9%
- Rate of depreciation at 8.33%	0.48	3%
- Adjustments to manpower costs	1.63	10%
- Others	1.01	6%
Tariff determined by PNGRB	**23.99**	

Source: PNGRB, Nomura research

Long but not a progressive tariff order

Even as the tariff order is much longer and PNGRB has tried to explain in detail the rationale on several issues, we think it is not a progressive order. It would create more confusion in the near term, and as it is applied with retroactive effect, the order itself could become stale very soon.

We highlight few of issues:

- Insistence on retroactive implementation from Nov-2008
- Order only for GSPL's high-pressure network. It is silent on its low-pressure network. The network is operated as a single network and GSPL does not disclose its numbers separately for these two networks. Given that order is coming after such a delay, we think an order for both networks together would have made much more sense.
- Insistence on accounting depreciation rate of 8.33% for periods prior to April-2010, even as the Ministry of Corporate Affairs has now allowed the rate of 3.17%. For its book of accounts GSPL had charged the rate of 8.33% as conservative accounting, but for tariff calculations it was asking for the permitted rate. PNGRB has disallowed this on the grounds that it would result in higher net fixed assets and thus a higher tariff. We think if the rate was allowable, it should have been given.
- PNGRB has considered an inflation rate of only 4.5% as per "extant practice". This rate is too low, in our view, when current headline inflation rates range 8-10%.
- Disallowed ongoing capex of INR10mn per km of spur pipelines beyond FY15, as GSPL could not give enough data. In our view, adding spur pipelines in a network is an ongoing phenomenon, and such pipelines do not take more than two years to build. The 50km of spur pipelines each year looks reasonable to us.
- Continues to disallow unaccounted for gas. Even as GSPL submitted that such losses are industry wide, and cited international reports/ practices, PNGRB did not agree similar to earlier orders.

Appendix A-1

Analyst Certification

We, Anil Sharma and Ravikumar Adukia, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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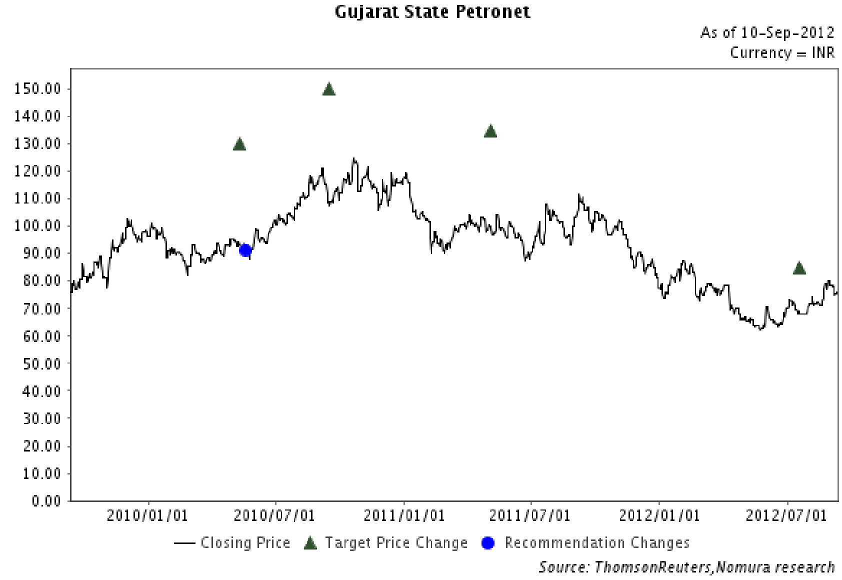
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Gujarat State Petronet	GUJS IN	INR 75	11-9-2012	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Gujarat State Petronet	Not Rated	11-5-2010

Gujarat State Petronet (GUJS IN) **INR 75 (11-9-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
19-Jul-12		85.00	67.95
05-May-11		135.00	98.80
15-Sep-10		150.00	109.25
11-May-10	Buy		93.50
11-May-10		130.00	93.50

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

Valuation Methodology We use a DCF methodology to value GUJS, assuming a WACC of 11.7% and a terminal growth rate of 2.5%. Our DCF model covers cash flows from FY14F to FY24F. Our DCF-based target price is INR85.

Risks that may impede the achievement of the target price Key downside risks: Higher-than-expected decline in transmission volumes, a sharp cut in transmission tariffs by PNGRB

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STOCKS

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