Equity Research

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Sector update

Oil & Gas and Petrochemicals

GGL (BUY)
Target price: Rs349

IGL (SELL)
Target price: Rs333

MGL (REDUCE)
Target price: Rs817

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INDIA

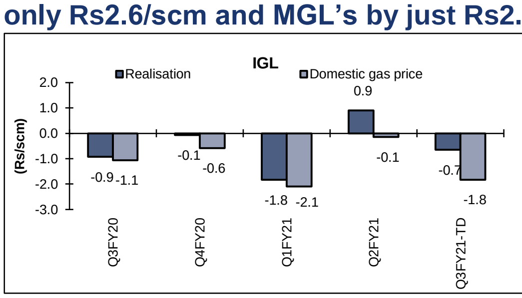
Gas sector

CGD: Competition to hit margins, volumes and lead to derating

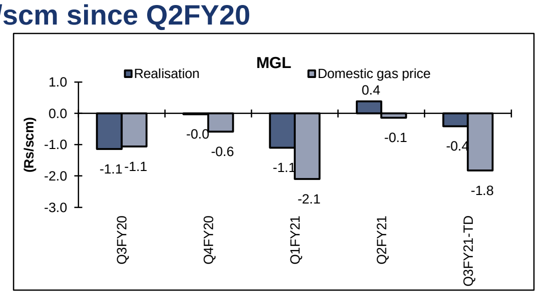
With PNGRB notifying access code and determination of transportation rate for CGD regulations, the decks are now cleared for competition in CGD areas where marketing exclusivity is over. PNGRB is now likely to allow competition in these CGD areas one by one. Incumbents may take the matter to Delhi High Court (HC), which may at best delay the advent of competition. OMCs, which are likely to emerge as the main competitors, have fired the first salvo by asking for 90-100% rise in their commission w.e.f. FY19. <u>Regulations not allowing OMCs to terminate agreement with incumbents to install their own CNG dispensers is not as big a positive for incumbents as some believe; it would have meant plunge in volumes, which neither the stock nor any investor was pricing-in. Regulations appear to require OMCs to install CNG dispensers only in stations where incumbents do not have a presence. This may mean competition hits incumbents' volumes and margins gradually, but a downward trend appears imminent.</u> We reiterate SELL / REDUCE on IGL / MGL, and BUY on GGL (least impacted by competition).

- **Any challenge in court to competition being allowed unlikely to succeed**: CGD players may challenge competition being allowed in Delhi HC as it had in Sep'15 ruled that any order by PNGRB allowing competition would be subject to further order by it. PNGRB is confident that its regulations would pass muster with Delhi HC. CGD players boosting EBITDA margin by not passing on the full benefit of fall in domestic gas price and PNGRB not allowing OMCs to take over incumbent's existing CNG stations on their site would hurt their case in Court. **GoI had in Feb'14 directed CGD players to fully pass on the benefit of fall in gas costs and said it would stop supply of cheap domestic gas to CGD players who don't pass on the full benefit. Competition will make this provision implementable.**

Domestic gas price down by Rs5.7/scm while CNG realisation of IGL down by only Rs2.6/scm and MGL's by just Rs2.3/scm since Q2FY20



Source: Industry data, PPAC, I-Sec research



Source: Industry data, PPAC, I-Sec research

- **Key provisions of the regulations:** At least 20% of the CGD network and compression capacity would have to be made available for open access to new entrants as per the regulations. PNGRB in the call with investors on 6-Jul'20 had stated that if spare capacity is more than 20% of network capacity, it may have to be offered for open access. **As per our discussion with PNGRB, regulations do not allow OMCs to terminate agreement with incumbent and set up their own dispensers in CNG stations where incumbent had one as PNGRB wants new infrastructure creation. Whether OMCs can set up own dispensers while continuing to dispense CNG for incumbents is a grey area;** PNGRB said "probably that may also not be allowed". Even if OMCs can install CNG dispensers only at stations where incumbents do not have a presence, it can only delay competition, which would eventually hit volume growth and margins of incumbents.
- **OMCs likely to emerge as formidable competitors**: The three OMCs are likely to emerge as formidable competitors in Mumbai, Delhi and Pune and hurt IGL and MGL. 60% of IGL's volumes and 60-65% of MGL's volumes are from CNG stations, which are on OMC sites. OMCs, who currently receive commission of Rs3.7-4.0/kg on CNG have demanded 90-100% rise in their commission retrospectively w.e.f. Apr'18. Thus, while incumbents would charge new entrants (likely to be OMCs) cost plus 12% return tariff for use of at least 20% of their transmission capacity, OMCs can charge incumbents high commission for use of their sites to dispense CNG.

Regulation allowing competition notified

OMCs to emerge as competitors; competition to hit margins

PNGRB likely to allow competition in CGD areas one by one

PNGRB has notified access code and transportation rate determination regulation for CGD networks. It would now move forward to declare CGD networks as common carrier or contract carrier one by one, and allow competition.

Competition likely 141 days after common carrier declaration

The timeline required to be followed by incumbents post getting declared as common or contract carrier is:

- Incumbents will have to determine capacity available for open access (at least 20% of total network capacity) within 90 days.
- Incumbents will have to develop a portal for receiving offers for capacity booking and allotment within 90 days.
- The aforementioned information on capacity will have to be published on website seeking capacity booking offers within 21 days.
- Shippers are required to submit offers to book capacity within 90 days from publication of document seeking capacity booking.
- Incumbent will have to vacate capacity for open access and finalise capacity booking within 30 days from receipt of booking request from shippers.

Not fully passing on gas cost fall may hurt CGD players' case in Court

EBITDA margin of CGD players surged to record high in Q2FY21 as full benefit of fall in gas cost was not passed on to the consumers. Gas cost fall was not passed on even in pre-Covid era (Panna, Mukta & Tapti gas price fall not passed on from end-Dec'19 to Mar'20) despite GoI guideline of 3-Feb'14 stating that any decline in domestic gas cost would have to be fully passed on to consumers. CGD players boosting EBITDA margins by not fully passing on benefit of fall in domestic gas price to consumers may hurt their case if they challenge competition being allowed in Court.

Competition to allow cancelling domestic gas supply if cost fall not passed on

Another guideline issued on 18-Feb'14 stated that non-compliance with passing on the entire benefit of fall in gas cost would lead to cancellation of CGD players' domestic gas allocation for CNG and domestic PNG. This guideline was not implementable without hurting consumers when there was a monopoly. However, once competition is allowed, this provision to cancel supply of cheap domestic gas to players, who do not pass on gas cost fall, can be implemented. **Thus, CGD players' EBITDA margin, which has seen secular rise in last few years, is likely to come under pressure with the advent of competition.**

OMCs likely to emerge as formidable competitors

OMCs, which have authorisation for 77 CGD areas, have repeatedly hinted that they are keen to foray in to large-volume CGD areas like Delhi, Mumbai and Pune when competition is allowed. They would be formidable competitors given that 60% of IGL's volumes and 60-65% of MGL's volumes are from CNG stations, which are on OMC sites. Moreover, OMCs, who currently receive commission of Rs3.7-4.0/kg on CNG have demanded 90-100% rise in their commission retrospectively w.e.f. Apr'18. Thus, while incumbents would charge new entrants (likely to be OMCs) cost plus 12% return tariff for use of up to, or over, 20% of their transmission capacity, OMCs could charge incumbents hefty commission for use of their sites to dispense CNG.

Competition to hit IGL and MGL; GGL to be least impacted

IGL most vulnerable to derating and MGL to margin contraction

Competition is likely to lead to de-rating and margin fall. We believe IGL is most vulnerable to de-rating and MGL to margin contraction once competition kicks in. We reiterate **SELL** on IGL and **REDUCE** on MGL.

GGL to be less hit by competition; volume outlook better than peers

Among CGD players we prefer GGL as:

- It would be least hit by competition given its CNG volumes are smaller and spread over a much larger geographical area than IGL and MGL. In Morbi, potential competitor GAIL will find it difficult to compete given its high-priced long-term contracted LNG volumes *vs* GGL's cheaper spot LNG-dominated volumes.
- GGL is the best play on NGT / Court orders requiring polluting fuels to be replaced by gas as areas it operates in are dominated by industrial volumes.

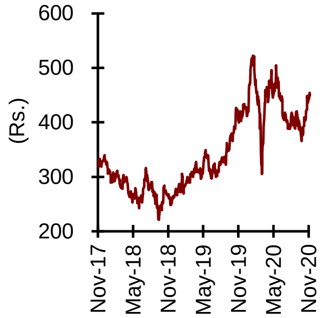
We reiterate **BUY** on GGL.

Upside to FY21E-FY22E EPS 25-15% & FV 23% on optimistic estimates

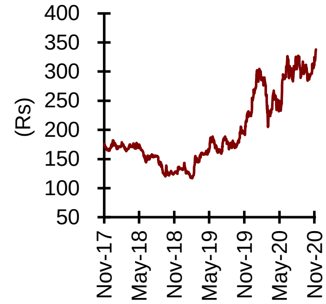
Our FY21E EPS rise of 9% YoY is based on conservative assumption of volumes of 8.6mmscmd (implied 10.2mmscmd in H2). Upside to our FY21E EPS would be 25%, FY22E EPS 15% and to fair value 23% to Rs430/share if based on more optimistic volume assumptions. Optimistic scenario factors current volumes of ~10.5mmscmd, FY21E exit volumes of 11mmscmd as guided by the company, and gains from NGT order. This would mean volumes at 9mmscmd in FY21E and 11.5mmscmd (10,3mmscmd in base case) in FY22E. In this scenario, FY21E EBITDA margin is Rs6.25/scm vs Rs5.5/scm in the base case.

Price charts

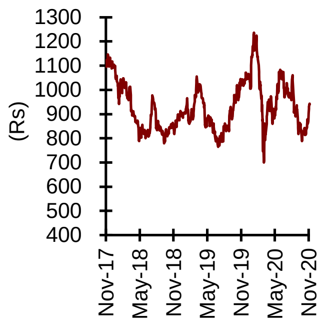
Indraprastha gas



Gujarat Gas



Mahanagar Gas



Source: Bloomberg

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