

Indian Oil & Gas

Fuel(ling) Reforms

■ Industry Overview

- **A promising start on the policy front** — The new year has turned out to be a harbinger of good news for the beleaguered Indian oil & gas sector. After a dismal 2012, which saw stocks (with the exception of BPCL) underperforming the mkt by ~5-60%, 2013 has provided a promising start on the back of the following key gov't-led initiatives which partly address some of the issues raised by us in our Mar'12 report titled, '[Oil Gauge - Darkest Before Dawn: Key Upstream Policy Asks](#)'.
- **Proposal for market-linked gas pricing** — The Dr Rangarajan committee has proposed: (1) a new simpler, more transparent, and easier to monitor fiscal model for future PSCs based on production levels and prices which would replace the existing cost-recovery based model, and (2) that Indian gas producers should get at least the avg price of what producers globally are getting to incentivise upstream investments while avoiding cartelisation. The formula proposed for the latter — based on an avg of: (i) the avg netback price of Indian imports at the wellhead of the exporting country, and (ii) weighted avg gas prices in the three major global hubs of US, UK, and Japan — could lead to a gas price of ~US\$8/mmbtu. This is a +ve for RIL, potentially providing it with clarity for its capex plans, though it is largely priced in to Street estimates. Gov't-owned upstream firms such as ONGC, etc could also be beneficiaries, albeit in the long term, as the gov't's subsidy compulsions may delay implementation of price hikes for gas produced from their nominated blocks. Improved visibility on ramp-up of domestic gas could also be beneficial for the gas value chain in the longer term, esp. for firms such as GAIL, etc.
- **Exploration approval for producing blocks** — The oil ministry has (*source: FE*) granted its long-awaited approval for carrying out exploration activities in producing blocks. The DGH had previously taken the rather detrimental view that further exploration in mining leases was not permitted. The oil ministry has now allowed for such exploration with 'ring fencing', i.e., it would be conditional on the cost of exploration being recovered only when a commercial discovery is made in order to protect the gov't's profit share from existing discoveries. The key beneficiary would be Cairn (CAIL.BO; Rs337.40; 1), as it is an important first step in enabling it to monetise its 530 mmboe of exploration prospects (contributes Rs75/sh to our NAV), which are critical for it to realise its long-term goal of producing 300 kbpd from Rajasthan.
- **Potential staggered diesel and kerosene hikes** — Recent press reports (*source: ET*) suggest that the oil ministry is considering putting forth a proposal to implement staggered price hikes in diesel and kero. With the OMCs currently losing ~Rs9/l on diesel and ~Rs30/l on kero, the intent is to raise diesel prices by ~Rs1/l each month till it achieves break even and raise kero by cRs10/l over two years. Such a move could, in two years, drastically reduce the industry's under-recoveries to a fraction of the cRs1.6tr estimated for FY13 (on our bearish crude view), with the gov't-owned oil companies, viz. BPCL, HPCL, ONGC, OIL, GAIL being key beneficiaries.

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Fuel(ling) Reforms

Rangarajan Committee Recommendations

Background

The Gov't of India had constituted a Committee to look into the two contentious issues of: (1) structure of Production Sharing Contracts (PSCs) in the Indian petroleum industry, and (2) pricing of domestically produced gas. This committee was headed by Dr C Rangarajan, the Chairman of the Economic Advisory Council to the Prime Minister. The purpose of this exercise was to enhance oil and gas production along with the gov't's share of profits as well as to minimize the gov't's monitoring of expenditure in oil and gas blocks. This initiative had been undertaken in the backdrop of falling gas output in the deepwater KG-D6 block, with the operator RIL mired in arbitration with the gov't on the issue of cost recovery for expenditure incurred in the block. RIL had also been pushing for a hike in gas prices from the current levels of US\$4.2/mmbtu and had demanded prices linked to imported LNG.

The Rangarajan committee set itself the following key objectives:

- Review of the current profit-sharing mechanism in PSCs, which is based on the Pre-tax Investment Multiple (PTIM)
- Minimizing gov't monitoring of the expenditure incurred in oil and gas blocks
- Securing the gov't's share or 'take' from oil and gas blocks
- Formulating guidelines for the pricing of domestically-produced gas

Proposed changes to gas pricing

The Rangarajan committee has proposed the following changes in the mechanism for determining the prices of domestically produced gas:

- As per the proposed pricing formula, domestic gas prices will be calculated as the average of two prices:
 1. The volume-weighted average of 'netback prices' of Indian LNG imports at the wellhead of the exporting countries. These prices will therefore exclude pipeline tariffs, liquefaction costs, shipping costs, import duties, etc as these do not accrue due to production activity. This would represent the average global price for Indian imports.
 2. The volume weighted average of natural gas prices in three major markets of US (Henry Hub price), UK (NBP or National Balancing Point price), and Japan (netback price at the supply source).
- The committee has recommended that the new pricing formula will only be applicable prospectively.
- The gov't will continue to retain the freedom to price crude, gas, and condensate. Thus, the committee has not proposed to grant pricing/marketing freedom to contractors.
- The committee has rejected the proposal of some sectors for limited sectoral gas-on-gas competition with allocations decided by the gov't. It has opined that gas-on-gas competition is only possible if import infrastructure in the country is improved. It has also rejected pricing linked to liquid fuels, stating that fertiliser

and power consumers in India are mandated by the gov't to use gas and thus liquid fuels are not a substitute in these cases.

- The gov't could review the situation after five years to examine the feasibility of gas-on-gas competition for pricing.

Proposed changes to future PSCs

With respect to the structure of the Production Sharing Contract, the committee has proposed a production-linked payment system while doing away with the extant system which was based on cost recoveries and Investment Multiples. The key changes to the fiscal model are explained below:

- **Production level and price band linked profit sharing** – The gov't's share of oil and gas revenues from the block will now change with two parameters: (1) the average daily production level in a given period (qtr/year), and (2) the average prices during the period. Thus, the PSC will stipulate a two-dimensional matrix with production tranches on one axis and price bands on the other, with the gov't take increasing with rise in both production as well as price levels. Currently, higher gov't take comes at a later stage in the life of a block, with the gov't bearing higher cost risks, thereby reducing the NPV of the gov't share. The current model will result in gov't sharing any windfall profits from price spikes or surprise finds.
- **Production share to be determined post royalty** – Under the new PSC, the gov't take will be determined on revenues from oil as well as gas post royalty. The royalty rate will continue to be based on an ad valorem rate (i.e., based on revenues and not on production levels) applied to gross revenues. The gov't (and the contractor's) take will then be based on revenues post royalty.
- **Cost recovery eliminated** – Therefore, by basing the gov't take on production and price levels, the committee has proposed to do away with the current system where the contractor is allowed to recover costs (capex and opex) incurred on the block before sharing revenues with the gov't. This also does away with the need to calculate Investment multiples, which earlier determined the level of gov't take.
- **Profit share to be biddable parameter** – When auctioning blocks, the gov't will make the profit share the biddable parameter, with separate bids for oil and gas. The gov't will then evaluate bids by calculating the NPV of the gov't take (calculated @ 10% for each price band separately and summed up for oil and gas; higher price of the band to be used).
- **Other features** – Some of the other salient features of the proposed new PSC are:
 - The price-production matrix for determining gov't take will be designed separately for land, shallow, and deepwater blocks and will be separate for oil and for gas production.
 - These production tranches/price bands can be 'modified or fine-tuned later'.
 - The new system should be applicable for future contracts only, maintaining the sanctity of existing contracts.

- An income tax holiday for seven years from the date of commencement of production should remain (should be extended to ten years for ultra-deep water blocks) for both oil and gas.
- The exploration period for frontier and deepwater blocks should be extended from seven to ten years. Further exploration should be allowed throughout the mining lease period in a mining lease area.

The Rangarajan committee also proposed changes to the administration of blocks:

- The Management Committee (MC) will no longer be involved with approving budgets and auditing accounts/appointing auditors. The main tasks of the MC in the new system will involve monitoring production levels, reviewing appraisal programmes, Declarations of Commerciality (DoCs), proposals of development programs, etc. The composition of the MC will remain same (i.e. both gov't and contractors will be represented). The gov't will therefore focus on technical issues like reservoir management and enhanced oil recovery rather than cost issues.
- The committee has upheld the right of the CAG to audit blocks in order to monitor the gov't take.

Cairn India

Valuation

Our Rs377 TP is based on NAVs of under-development and producing assets and incorporates recovery upside. Given Cairn's leverage to crude, our target of Rs377 is based on an average Mar-13E NAV value derived using two different crude scenarios: 1) Citi crude price forecasts yielding NAV of Rs387, and 2) Brent crude forward curve yielding NAV of Rs404. We believe that the stock would partially factor in a combination of longer-term fundamentals and near-term momentum in underlying crude prices, till it can establish a track record of success outside Rajasthan. We use a 5% discount to NAV to factor in uncertainty on Cairn's use of cash following the change in ownership, though clarity has improved recently on medium-term capex plans, which are, however, contingent on gov't approvals.

Assumptions for our NAV are: Brent prices of \$107/98/90 over FY13/14/15E; long-term (real) Brent price of \$80; crude realization at a 12% discount to Brent; royalty at ~15% of revenue; cess at Rs4,500/MT; plateau production at 230kbpd in 1H14; and total life-of-field development capex (including pipeline) of \$6.6bn. We use WACC of 11% derived from 10% cost of debt and 13.9% cost of equity using equity beta of 0.9, 8.5% risk free rate, 6% risk premium, and 40% target D/V. Traditional valuation multiples (P/E, EV/DACF) will become relevant depending on the extent of future exploration success.

Risks

Key downside risks include: 1) Delay in regulatory approvals for production ramp up, revisions to development plans, further exploration, etc; 2) Project execution risks resulting in slow ramp up and/or cost overruns; 3) Infrastructure constraints in downstream capacity (pipelines, processing terminals, etc) which could delay ramp-up timelines; 4) Difficulty in absorbing the crude quantities due to its viscosity and various refineries' readiness; 5) Concerns on strategy and use of cash post the change in ownership; 6) Sharp correction in crude prices; 7) Sharp appreciation of the currency.

Appendix A-1

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Ratings and Target Price History Fundamental Research

Analyst: Saurabh Handa

Covered since June 18 2010



	Date	Rating	Target Price	Closing Price
1	13-Jan-10	*1L	*337.00	294.05
2	28-Jan-10	1L	*323.00	270.45
3	14-Apr-10	1L	*351.00	302.95
4	28-Jul-10	*2L	*363.00	328.90
5	7-Oct-11	Stock rating system changed		

* Indicates change

	Date	Rating	Target Price	Closing Price
6	20-Oct-11	*1	363.00	293.90
7	21-Oct-11	1	*340.00	289.10
8	13-Dec-11	1	*358.00	307.20
9	6-Feb-12	1	*400.00	357.10
10	12-Mar-12	1	*412.00	372.35

	Date	Rating	Target Price	Closing Price
11	20-Mar-12	1	*380.00	358.75
12	22-Apr-12	1	*422.00	346.80
13	4-Jun-12	1	*375.00	306.70
14	5-Aug-12	1	*377.00	334.60

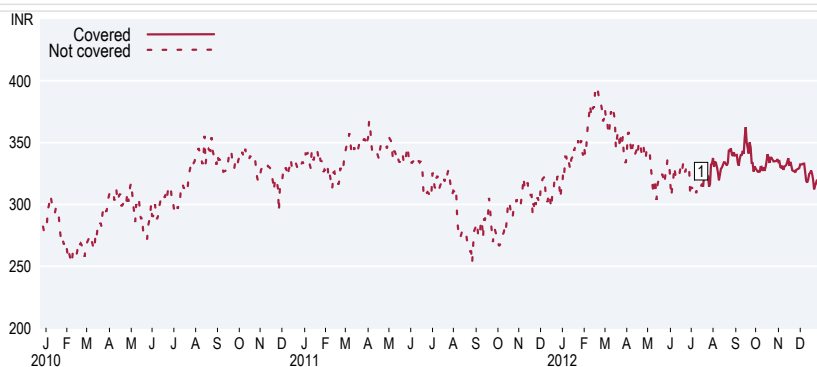
Rating/target price changes above reflect Eastern Standard Time

Cairn India (CAIL.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Saurabh Handa

Covered since June 18 2010



	Date	Rating	Target Price	Closing Price
1	16-Jul-12	*ADD MP	-	315.15

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Data current as of 31 Dec 2012

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