

Case No. OGRA-6(2)-2(3)/2006-DTRR (Review)

IN THE MATTER OF

**SUI SOUTHERN GAS COMPANY LIMITED
MOTION FOR REVIEW OF FRR, FY 2005-06**

UNDER

**OIL AND GAS REGULATORY AUTHORITY
ORDINANCE, 2002 AND
NATURAL GAS TARIFF RULES, 2002**

DECISION

November 25, 2006

Before:

**Munir Ahmad, Chairman
Jawaid Inam, Member (Gas) / Vice Chairman
Rashid Farooq, Member (Oil)
M.H. Asif, Member (Finance)**

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1. BACKGROUND

- 1.1. Sui Southern Gas Company Limited (the petitioner) is a public limited company incorporated in Pakistan, and is listed on Stock Exchanges at Karachi, Lahore and Islamabad. It is engaged in the business of construction and operation of gas transmission & distribution pipelines, sale of natural gas and gas condensate as by-product, and manufacture & sale of gas meters.
- 1.2. The petitioner had filed a petition under Section 8(1) of the Oil and Gas Regulatory Authority Ordinance, 2002 (the Ordinance) for determination of estimated revenue requirement for FY 2005-06 (said year) on December 14, 2004. Subsequently the petitioner amended it on March 4, 2005. The Authority determined petitioner's estimated revenue requirement for the said year, vide its decision dated May 20, 2005. On August 16, 2006, the petitioner filed a petition under Section 8(2) of the Ordinance for determination of its Final Revenue Requirement (FRR) for the completed year. The Authority determined the FRR vide its detailed order dated September 25, 2006. Aggrieved by this determination, the petitioner has submitted the instant review motion (the petition) dated October 22, 2006, under Section 13 of the Ordinance read with Rule 16 of the Natural Gas Tariff Rules 2002 (NGT Rules), seeking increase in prescribed price of Rs. 3.27/MMBTU.
- 1.3. A statement giving comparison of cost of service submitted by the petitioner and the determination of FRR FY 2005-06, is given below:



Table 1 : Comparison of Cost of Service for FY 2005-06 per the petition with FRR

Particulars	FY 2005-06		Rs. in million	
	FRR	The Petition	Increase / (Decrease) over	
			FRR	
				Rs./MMBTU
Units sold BBTU	338,126	338,126	-	
Cost of gas sold	59,648	59,621	(27)	(0.08)
Unaccounted For Gas(UFG)	(478)	(451)	27	0.08
Transmission and distribution cost	4,497	4,596	99	0.29
Depreciation	2,139	2,193	54	0.16
Return on net average operating fixed assets	3,168	3,176	8	0.02
Other operating income	(4,557)	(3,667)	890	2.63
Reclaimed Item	48	104	56	0.17
Net Operating Expenses	64,465	65,571	1,106	3.27

2. AUTHORITY'S JURISDICTION AND DETERMINATION PROCESS

2.1. The petitioner has invoked the jurisdiction of the Authority under Section 13 of the Ordinance read with Rule 16 of the NGT Rules. Section 13 provides the grounds on which a review petition can be filed, and is reproduced below:-

***“13.Review of Authority decision.-** The Authority may review, rescind, change, alter or vary any decision, or may rehear an application before deciding it in the event of a change in circumstances or the discovery of evidence which, in the opinion of the Authority, could not have reasonably been discovered at the time of the decision, or (in the case of a rehearing) at the time of the original hearing if consideration of the change in circumstances or of the new evidence would materially alter the decision.”*

2.2. The review can be carried out if the issues brought forward by the petitioner meet at least one of the two pre-conditions given in the said Section 13, and would materially alter the decision under review.

2.3. The Authority admitted the petition on November 1, 2006 and issued a notice of conference on November 07, 2006, to the petitioner and the Federal Government.

2.4. The Authority held the conference at OGRA office, Islamabad on November 22, 2006.

3. PROCEEDINGS



- 3.1. The petitioner was represented at the conference by a team led by Mr. Muhammad Abid Sherani, its Chief Financial Officer, who was given full opportunity to present the petition. The petitioner made submissions in detail with the help of multi-media presentation and answered questions put by the Authority and its officers.
- 3.2. The petitioner has sought review of the Authority's decision on the items which are discussed and decided in the succeeding paragraphs.

4. INCOME ON IAS 19 PROVISION

4.1. Petitioner's Grounds for Review

- 4.1.1. The petitioner has requested to exclude the notional interest income on IAS 19 provision, amounting to Rs. 150.30 million from tariff workings on the ground that the interest income is expressly excluded from ADB loan covenant. Further, it had never invested these funds, therefore, no interest income could be generated.
- 4.1.2. The petitioner has further argued, without prejudice to its above contention on the issue, that OGRA had first raised this issue in FY 2004-05, and therefore, should make adjustments prospectively.

4.2. Discussion and Decision

- 4.2.1. The points made in the instant petition have been raised earlier and discussed by the Authority per para 5.2 of its decision on review motion of ERR for FY 2005-06. No new argument or evidence has been put forth. ***The Authority maintains its earlier decision in this respect.***

5. OTHER CHARGES-EARTHQUAKE RELIEF



5.1. **Petitioner's Grounds for Review**

5.1.1. The petitioner has requested to allow contribution amounting to Rs. 30 million towards earthquake relief activities including contribution to GoP, provision of relief goods and payment to the petitioner's affected employees on the plea that it does not fix its sales price, cost of gas, profit etc, on its own like other commercial concerns.

5.2. **Discussion and Decision**

5.2.1. The Authority deeply appreciates that the petitioner has contributed like other responsible citizens and corporations in rehabilitation of earthquake affectees; however cannot allow its recovery from the consumers through the tariff setting mechanism. That will be incorrect legally, as well as morally. Citizens and corporate sector of Pakistan have also donated generously out of their own resources and so should SSGCL.

5.2.2. The Authority, however, observes that the sum of Rs. 4.290 million paid by the petitioner to its earthquake affected employees, can be classified as part of HR cost. ***The Authority, therefore, will allow adjustment of Rs. 2.145 million only (i.e. 50% per HR cost benchmark) on this account in the final revenue requirement for FY 2006-07.***

6. **DEPRECIATION ON GAS METERS**

6.1. **Petitioner's Grounds for Review**

6.1.1. The petitioner has requested to allow depreciation amounting to Rs. 25.641 million on gas meters disallowed by the Authority per FRR FY 2005-06 and Rs. 0.405 million on prepaid meters disallowed in FRR's of FY 2004-05 and FY 2005-06. The petitioner has pleaded that change in useful life should be considered as change in estimates and not change in policy per IAS 16. Had it been a change in policy, the same would have been reflected in the annual accounts. The Board of Directors has also approved this change,



which is based on the technical evaluation by the meter departments of both the utilities, which suggests that after 12-13 years, meters start malfunctioning and resultantly pass unregistered gas, contributing towards UFG.

6.1.2. The matter of prepaid meter is being dealt with separately by the Authority, therefore, this issue has not been raised in this petition.

6.2. Discussion and Decision

6.2.1. The Authority observes that the petitioner cannot change the depreciation rate / useful life of its assets without obtaining prior approval of the Authority in accordance with Rule 17(k) of NGT Rules 2002.

6.2.2. The petitioner has not provided comprehensive historical analysis and technical study in support of its claim of reduction in useful life of meter to 10 years. The Authority is, therefore, unable to evaluate into the merit of the petitioner's claim.

6.2.3. The Authority observes that the depreciation rates for various assets in operation are an integral part of any tariff regime. The Authority is obligated to follow the current regime under the policy guideline issued by the Federal Government to OGRA on October 11, 2002, till such time that an appropriate rate of return is determined in consultation with the Federal Government and the utilities. The new regime, developed by OGRA, is presently under the Federal Government's consideration.

6.2.4. ***In view of the above, the Authority maintains its earlier decision of not allowing accelerated depreciation.***

6.2.5. The Authority notes the petitioner's statement that since the issue of prepaid meters is being separately dealt by the Authority, the same has not been raised.

6.2.6. ***The Authority will decide the issue related to pre-paid meters separately.***



7. DEPRECIATION ON VEHICLES

7.1. Petitioner's Grounds for Review

7.1.1. The petitioner has contended that the Authority disallowed addition to vehicles in FRR FY 2004-05 amounting to Rs. 138 million without giving any cogent reason. The reason offered is that the actual cost differs from the estimated cost, which does not mean that the cost was not incurred prudently.

7.1.2. The petitioner has stated that the said vehicles are deployed in activities related to implementation of massive development plan of transmission and distribution network. OGRA, in its decision, dated September 27, 2006 on motion for review of ERR for FY 2006-07, has also referred Rule 17(iv) of NGT Rules, 2002, which advocates reasonable investment. The same is reproduced below:

“Tariffs should be determined in a manner which promotes continued reasonable investment in equipment, facilities and research and development for qualitative and quantitative improvement in the provision of regulated activities”

7.1.3. These vehicles had remained in operation during FY 2005-06 and have contributed towards the revenue generation for the company. Had these assets not been purchased in FY 2004-05, company would have to procure them in FY 2005-06, therefore, disallowance of these vehicles for the said year is not justified.

7.1.4. In view of the above, the petitioner has requested the Authority to allow addition to vehicles amounting to Rs. 138 million in FY 2004-05 and Rs. 110.40 million in the opening balance of the assets base for the said year.

7.1.5. Consequent upon the above addition, the depreciation of Rs. 28.017 million for each of the two financial years, 2004-05 and 2005-06 and return on assets of Rs. 10.03 million and Rs. 17.68 million for FY 2004-05 and FY 2005-06 respectively, may also be allowed.



7.2. Discussion and Decision

- 7.2.1. The arguments raised by the petitioner for allowing addition to vehicles amounting to Rs. 138 million, disallowed in FY 2004-05, have already been discussed by the Authority while deciding the issue, in its decision on FRR FY 2004-05 and the subsequent motion for review.
- 7.2.2. The petitioner's present contention that the said vehicles, in any case, remained in operation during FY 2005-06, and had these vehicles not been there in FY 2004-05, these would have to be procured in FY 2005-06, has merit. ***The Authority, allows Rs. 110.4 million and 82.8 million in the opening and closing balances of net operating fixed asset base, respectively. Consequently, sums of Rs. 27.6 million and Rs. 16.4 million on account of depreciation and return on assets respectively, are allowed for the said year, in respect of vehicles. These adjustments however, will be made at the time of determination of FRR FY 2006-07.***
- 7.2.3. ***The Authority reiterates its direction per para 7.5 of FRR 2003-04, that the petitioner must obtain OGRA's approval prior to incurring any expenditure over and above the amount and scope of work permitted while determining estimated revenue requirement.***

8. EXCESS DEPRECIATION DISALLOWED IN FY 2004-05

8.1. Petitioners' Ground for Review

- 8.1.1. The petitioner has requested to allow a sum of Rs. 19.25 million, being the "excess disallowed depreciation" computed by the Authority at higher rate of 20% instead of 6% under the ADB loan covenants per FRR FY 2004-05. Reduction of depreciation in FY 2004-05 has seriously hampered the ADB loan covenant. The matter was explained earlier also while presenting the motion for review of final revenue requirement for FY 2004-05, but remains unsettled. Had these assets not been acquired, the depreciation charges at 6% of the gross value of fixed asset would have been Rs. 2,173 million as compared to Rs. 2,154 allowed by the Authority.



8.2. Discussion and Decision

8.2.1. The Authority notes that the petitioner has not provided depreciation schedule for FY 2004-05 to enable verification of the claimed amount. Therefore, the claim is unsubstantiated at this time.

8.2.2. ***In view of the above, the Authority provisionally maintains its earlier decision, but would examine and decide it separately if adequate information is provided by the petitioner within 30 days from the date of this determination.***

9. THIRD PARTY DAMAGES

9.1. Petitioner's Grounds for Review

9.1.1. The petitioner has requested to allow 21 MMCF (Rs. 3.27 million) on account of sabotage activity and 152 MMCF (Rs. 23.67 million) due to third party damages in its distribution system.

9.1.2. The petitioner has stated that 21 MMCF gas loss on account of sabotage activities on distribution system was inadvertently not brought to the notice of the Authority and it remained disguised in the total volume of third party damages.

9.1.3. The petitioner has argued that, in Pakistan, special ducts are not provided to give through passage for civic amenities which results in damages to gas pipeline. Further, it is not practical to meter such losses, and therefore it has to rely on standard formula/practice for measurement of such lost gas.

9.1.4. The petitioner has stated that voluntary excess for such incident was agreed with the insurance companies, initially kept at Rs 2.5 million per incident. However, during FY 2004-05, no such incident had occurred, and therefore, in FY 2005-06, the voluntary excess was raised to Rs 20 million, resulting into saving of Rs 28.5 million in insurance premium. Thus, the third party damages are self insured to keep the insurance cost at the lowest possible level.



9.1.5. The petitioner has also reclaimed 132 MMCF (Rs 17.758 million) in respect of excess UFG calculated against third party damages for FY 2004-05 which had also not been allowed by the Authority.

9.2. Discussion and Decision

9.2.1. The Authority observes that it had already discussed and decided the issue of gas loss due to third party damages in its various earlier determinations. The petitioner has not brought forth any new arguments to justify its claim that the said losses do not form part of UFG. ***The Authority, therefore, maintains its earlier decision of disallowing the UFG to the extent of third party damages for FY 2004-05 and FY 2005-06.***

9.2.2. ***The Authority allows deduction of 21 MMCF of gas (Rs. 3.27 million) being the loss of gas due to sabotage activity on distribution network in computation of UFG. The adjustment on this account will, however, be made in the determination of FRR FY 2006-07.***

10. LATE PAYMENT SURCHARGE (LPS), METER MANUFACTURING PROFIT AND ROYALTY FROM JJVL

10.1. Petitioner's Grounds for Review

10.1.1. The petitioner has, once again, requested to allow the late payment surcharge, meter manufacturing profit and royalty income as non-operating income, while request was disregarded by the Authority on the ground that it was not originally included in petition filed under Section 8(1).

10.1.2. The petitioner has stated that there are instances where the Authority had included certain items in estimated/actual revenue requirements regardless of these being part of respective petitions filed under Section 8(1) or Rule 16. This approach, therefore, also fails to pass above test as outlined by the Authority. Further, the Authority had added notional income on IAS-19 provision in the operating income which had not been included in



the petition on estimated revenue requirement for FY 2005-06. The Authority, in its decision on motion for review for FY 2006-07, had also adjusted weighted average cost of gas which was not included in the ERR FY 2006-07.

- 10.1.3. The petitioner has further argued that the Authority, in its decision on motion for review of ERR for FY 2006-07, had stated that late payment surcharge and meter manufacturing profit issues had already been settled in its earlier determinations in accordance with the Federal Government's policy guideline, dated October 11, 2002, reproduced below:

“Till such time an appropriate rate of return is determined by the OGRA, in consultation with the Federal Government and the licensees, the OGRA shall determine the revenue requirements of the existing gas companies on the basis of the covenants stipulated in the loan agreements of SNGPL with World Bank and SSGCL with ADB”

- 10.1.4. Above directive has been quoted partly as OGRA in FRR FY 2001-02 has also included the following:

“For the financial years 2001-02 and 2002-03, OGRA shall undertake determination or review of the revenue requirements (prescribed prices) of the existing gas companies and make retroactive adjustments in accordance with the present procedure, which is being followed by the Federal Government”

- 10.1.5. The aforesaid directive pertains to removal of difficulties under Section 27 of the Ordinance, and it is evident that to-date no new policy guideline is available to OGRA, as it has relied upon this directive in its order dated September 27, 2006 also. This directive intended to facilitate OGRA in determination of revenue requirement of the utilities during FY 2001-02 and FY 2002-03 when the formal licenses to both utilities were under issue and even Natural Gas Tariff Rules were not promulgated. Therefore, OGRA was obligated to follow this procedure for FY 2001-02 and FY 2002-03 only and thereafter, must exercise its own judgment and should not rely upon prior GoP directive.

- 10.1.6. The petitioner has further argued that in the ADB loan covenants, there is no provision to deduct deferred credit from the asset while determining the



return. The previous Price Determining Authority (PDA) i.e. Director General, Gas (D.G. Gas), used to exclude the deferred credit from the assets, which is now being followed by OGRA. The petitioner has no objection for this treatment merely on the basis of omission in ADB loan covenant rather recognizes it as a justified treatment. This, itself, is a valid reason for rectification of wrong treatment in the past in respect of meter manufacturing profit and LPS, by OGRA. The petitioner has contested that the definition of return on asset has been derived from ADB loan covenants, which has been followed by PDA, stipulating operating and non-operating income and total operating expenses. Non-operating income has been defined as interests, dividends and other non-operating income. According to the definition, treatment of income from meter manufacturing is well justified as non-operating. Particularly, after promulgation of the Ordinance, this treatment is unlawful and cannot be continued even under the GoP policy guideline, as no policy can be issued against the law.

10.1.7. Further, the treatment of LPS as operating income was not justified even prior to the Ordinance as per ADB loan covenants and, therefore, its treatment as operating income cannot be admissible under the Ordinance.

10.1.8. The petitioner has mentioned that the ADB loan covenants have not specifically defined activities to be considered as operating income but defined in general term “revenue from all sources related to operations” as part of operating income.

10.1.9. The petitioner has also argued that royalty income from JJVL cannot be treated as regulated activity, under the Ordinance, rules framed there-under as well as license issued to it.

10.2. **Discussion and Decision**

10.2.1. The Authority observes that it is empowered under Section 13 of the Ordinance to suo, motto, review, rescind, change, alter or vary any decision.



- 10.2.2. The Authority notes that it has already discussed and decided the issue of treatment of LPS, meter manufacturing profit, royalty from JJVL, in its earlier determinations. No new argument or evidence has been put forth by the petitioner.
- 10.2.3. To arrive at correct interpretation of the Federal Government policy guideline dated October 11, 2002, its paras (i) and (ii) should be read together.
- 10.2.4. The Authority observes that the treatment of any components of the tariff regime (e.g. LPS, meter manufacturing profit and royalty from JJVL) cannot be changed in isolation, while the petitioner continues to get return @ 17% on fixed assets as stipulated in loan covenant. The tariff regime is a package and has to be enforced in totality. These issues can, however be sorted out while finalizing the new tariff regime, which is currently in the process of consultation with the Federal Government.
- 10.2.5. The Authority notes that the petitioner's understanding that the deduction of deferred credit was inherited from the earlier PDA (i.e. D.G. Gas) is not correct. This treatment is in accordance with Rule 17(i) of NGT Rules, 2002, which is reproduced below;

“while determining the value of a licensee's fixed assets in operation, the value of assets funded wholly or partially, on a non-refundable basis, by a person other than the licensee, should be excluded to the extent of such contribution;”.

- 10.2.6. ***In view of the above discussion, the Authority maintains its earlier decision of treating the LPS, meter manufacturing profit and royalty from JJVL as operating income for the said year. Consequently, the fixed assets relating to meter manufacturing business will remain part of the assets base as discussed in para 6.1.2 of FRR 2005-06 dated September 25, 2006.***



11. WORKERS' PROFIT PARTICIPATION FUNDS (W.P.P.F)

- 11.1. ***Consequent upon the adjustments as discussed in paras 5.2.2, 7.2.2 above and 9.2.2 above, the additional W.P.P.F has been worked out at Rs. 2.5 million, which will be allowed at the time of determination of FRR FY 2006-07.***

12. CONCLUSION

- 12.1. The petition is allowed only to the extent stated in para 5.2.2, 7.2.2, 9.2.2 and 11.1 above.

(M. H. Asif)
Member (Finance)

(Rashid Farooq)
Member (Oil)

(Jawaid Inam)
Member (Gas) /
Vice Chairman

(Munir Ahmad)
Chairman

Islamabad, November 25, 2006