Energy Churn Ahead
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Higher costs could lead to consolidation in city gas distribution

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HIGHER GAS COSTS will lead to faster consolidation in the city gas distribution (CGD) sector. The sector is facing headwinds from a sharp cut in the allocation of gas supplied under the administered price mechanism (APM) for the priority sectors — domestic piped natural gas (D-PNG) and compressed natural gas (CNG). The APM gas allocation for these segments has reduced from 72 per cent in the second quarter of the financial year to 44 per cent effective from November 16. This will compel players to rely on higher-cost alternate gas sources such as high-pressure high temperature (HPHT) gas or imported regasified liquified natural gas (RLNG), which costs one-and-a-half and two times respectively of the APM gas costs.

The higher share of HPHT and RLNG will likely increase the gas costs of players in the priority segment by around Rs 5.0 per standard cubic metre (scm) or Rs 7 per kg. Considering that D-PNG and CNG segments account for two-thirds of the sector's volumes, this will significantly impact the overall profitability of players. With imported contracted RLNG, new well gas and part of the HPHT gas (subject to a cap) being linked to crude prices, the current benign crude prices of $70-75 per barrel will only marginally offset the impact of lower APM allocation.

This increase in gas costs has come at a time when CNG is facing tough competition from diesel in the medium and heavy commercial vehicles and light commercial vehicle segments. The superior cost competitiveness of CNG vis-a-vis diesel has been steadily declining over the last several quarters. With benign crude prices that may pan out in the backdrop of Donald Trump's expected pro-drilling policies in the US, there's a distinct possibility of a price cut in diesel. This may narrow CNG's advantage even further.

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On the three-wheeler front that accounts for one-third of CNG consumption, new registrations for CNG vehicles have already flattened. Buses which account for 7 per cent of CNG volumes will experience faster electric adoption given the PM e-Bus seva scheme in several cities. All this is being manifested in a CNG volume growth slowing to 11 per cent in the first half of this and last year.

Given the above factors, CGD companies may be able to pass on the increase in gas costs only partly without impacting volumes significantly. To make up for the shortfall in APM gas, players will eventually replace the immediate procurement with HPHT gas or new well gas. Assuming only half of the gas cost increase is passed on to consumers, earnings (EBITDA) of the CNG segment are expected to reduce. This may wipe off Rs 2,300 crore from the profits of the CGD sector next financial year.

The commercial and industrial segment that accounts for one-third of CGD sector volumes is unlikely to offset this decline in profitability as it is extremely price sensitive. CNG consumption by this segment had declined by 25 per cent in 2022-23 due to an increase in gas prices driven by higher RLNG prices as competing fuels like propane gained in competitiveness.

As margins tighten, larger CGD players who have already incurred the majority capital expenditure on network and CNG pump infrastructure and with an ability to contract HPHT and RLNG at competitive rates are more likely to endure challenging times. A stronger balance sheet will also definitely help endure this transition. On the other hand, smaller entities which do not have strong parentage, relying on spot gas and facing substantial capital expenditure, will struggle. There are 11 areas which do not have strong parentage and will be prime candidates for being acquired.

Additionally, there are 61 areas across PSUs and entities backed by strong parentage where significant capital expenditure needs to be done and given constrained cash flows, their reliance on debt will increase. The stage is thus ripe for consolidation within the sector. The changing dynamics of the compressed gas distribution sector present both formidable challenges and potential opportunities.

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