

Case No. OGRA-6(2)-1(2)/2005-Review

IN THE MATTER OF

**SUI NORTHERN GAS PIPELINES LIMITED
MOTION FOR REVIEW OF DERR, FY 2005-06**

UNDER

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

DECISION

October 12, 2005

Before:

Munir Ahmad, Chairman

Jawaid Inam, Member (Gas) / Vice Chairman

M.H. Asif, Member (Finance)

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1. BACKGROUND

- 1.1. Sui Northern Gas Company Limited (the petitioner) is a public limited company incorporated in Pakistan, which is listed on the Karachi, Lahore and Islamabad Stock Exchanges. The company is engaged in the business of construction and operation of gas transmission & distribution pipelines and sale of natural gas.
- 1.2. The petitioner submitted a review motion (the review motion) on June 16, 2005 under Rule 16 of the Natural Gas Tariff Rules, 2002 (NGT Rules, 2002) for increase in prescribed prices of various categories of consumers, which were notified by the Authority on June 30, 2005 (*Annexure-I*) to give effect to its determination dated May 20, 2005 of Estimated Revenue Requirement (ERR) of the petitioner for FY 2005-06 of Rs. 93,354 million, under Section 8 (1) of the Oil and Gas Regulatory Ordinance, 2002 (the Ordinance) in case No. OGRA-6(2)-1(3)/2004.
- 1.3. The petitioner requested to allow increase of Rs. 1,643 million in its ERR of FY 2005-06 through increase in the prescribed prices of Rs. 3.29 per MMBTU and submitted the following comparative statement of cost of service:

Table 1: Comparison of Cost of Service per the Review Motion with ERR

Particulars	Rs. /MMBTU		
	FY 2005-06 DERR	The Review Motion 2005-06	Inc. / (Dec.)
Units Sold (BBTU)	499,479	499,479	-
Cost of gas	154.23	154.23	-
Transmission and Distribution Cost	12.55	13.77	1.23
Depreciation	8.47	8.62	0.15
Return on net average operating fixed assets	10.90	12.29	1.40
Other operating income	(3.83)	(2.55)	1.28
Deferral Account	0.76	-	(0.76)
Cost of service / prescribed price	182.31	186.36	4.05
Revenue available at existing prescribed	183.07	183.07	-
Shortfall in revenue requirement	-	3.29	3.29

- 1.4. The Authority issued a notice on 12th July, 2005 of conference in terms of Rule 6 of NGT Rules, 2002, to the petitioner, interveners and the Federal Government.

2. PROCEEDINGS



- 2.1. The Authority held the conference at Islamabad on August 04, 2005.
- 2.2. The petitioner was duly represented by a team led by its Deputy Managing Director, Mr. Muhammad Azam Khan. However, none of the interveners, Federal Government's representative participated.
- 2.3. The petitioner made submissions in detail with the help of multimedia presentation in the course of which it conceded Authority's determination of ERR 2005-06 pertaining to the following issues although earlier, in its review motion, it had contested the same.
 - a) Fixed assets opening balance
 - b) SCADA
 - c) Up-gradation of test cell
 - d) Emergency repair / warranty claim
 - e) Other assets
 - f) Other operating income
 - g) Gas internally consumed
 - h) Provision for doubtful debts
 - i) Insurance
- 2.4. The petitioner, however, sought review of the Authority's decision on the remaining items, which are discussed in succeeding paragraphs.

3. OPERATING FIXED ASSETS

3.1. Petitioner's Grounds for Review

- 3.1.1. The petitioner has requested the Authority to review its decision requiring submission of a separate certificate from the statutory auditors in respect of "actual cost incurred on each item of capital expenditure" and compliance with the Public Procurement Rules, 2004 (PPR) in respect of procurement of materials.
- 3.1.2. The petitioner argued that the statutory auditors conducted audit to meet the requirements of the Companies Ordinance, 1984 which included the opinion



that the accounts represented a true & fair view of the Company's overall financial position. In this process, the auditors certified the value of the "additions to fixed assets" also and it was unlikely that their report on individual assets would show different results. The petitioner also stated that substantial additional management time and direct cost would be involved, which would eventually be passed on to the consumers and delay the finalization of accounts and holding of AGM beyond the time limits prescribed under the Company law. The petitioner pleaded that reliance be placed upon audited accounts.

- 3.1.3. The petitioner pointed out that it had taken up the matter of mandatory compliance with the PPR 2004 with the Law Division, Government of Pakistan, pleading that these Rules did not apply to it, and requested the Authority to hold its decision in this respect in abeyance until the receipt of Law Division's opinion.

3.2. Discussion and Decision

- 3.2.1. Under Section 6 of OGRA Ordinance, the Authority enjoys wide-ranging powers for regulating the petitioner's activities and can ask for separate specific certification about any aspect of a regulated activity with a view to ensure effective regulation.
- 3.2.2. The requirement of auditors' certificates about cost of capital assets and compliance of PPR 2004 has been introduced in order to safeguard the interest of the consumers by ensuring that return is allowed on real cost of the assets, discouraging gold plating in any form and imprudent capital expenditure. It will also promote culture of economy and efficiency. The marginal additional cost that may have to be incurred to obtain these certificates is, therefore, well justified.
- 3.2.3. The petitioner, under clause 11 of its license, is obligated to adopt transparent and competitive procurement policies and procedures in relation to any of its regulated activities. The Authority, through its letter No. OGRA-1 (1) / 2004-SS&SN dated October 27, 2004, had made observance of PPR 2004 mandatory for both the gas utilities finding them comprehensive and laying down



transparent & competitive procurement policies & procedures. The Authority has reviewed this aspect in the light of the petitioner's contention and is of the considered view that observance of PPRA Rules 2004 would remain mandatory in pursuance of the Authority's direction mentioned above, irrespective of the opinion of Law Division, Government of Pakistan on the reference regarding their applicability to the petitioner.

3.2.4. The petitioner's contention that the statutory auditor's certification in respect of actual cost incurred on "each item of capital expenditure" is difficult to achieve has merit in view of the volume of transactions involved and the principle of materiality. However, the argument that it will delay the finalization of accounts is not convincing because such detailed audit can easily be conducted after the finalization of annual accounts and any required adjustments can be made later.

3.2.5. Considering all relevant aspects, the Authority decides that the petitioner is required to provide its statutory auditors' certification on the basis of detailed cost audit confirming the cost that could be reasonably attributed to each asset capitalized during a year, on the basis of reasonable levels of efficiency and cost effectiveness, if it falls within any of the under-mentioned categories:

- **Transmission:**

- Construction Machinery
- Pipelines (new/ replacements)
- Compressors/turbines
- SCADA
- Telecommunication

- **Distribution:**

- Pipelines (supply mains, extensions etc.) excluding the jobs with total value of less than Rs. 10 million.

3.2.6. For the same reasons as discussed in para 3.2.4 above, the Authority decides that auditors certification confirming procurement of assets and services being transparent, cost effective and in accordance with the PPR 2004, be limited to the following:



- Construction machinery
- Pipeline
- Regulators
- Valve and Fittings
- Coat and Wrap Materials
- Compressors/Turbines
- SCADA
- Service contracts excluding those valued at less than Rs. 50 million.

4. UNACCOUNTED FOR GAS (UFG)

4.1. Petitioner's Grounds for Review

- 4.1.1 The petitioner pleaded for review of UFG benchmark of 5.75% set by the Authority for FY 2005-06 and proposed gradual reduction to 4% by FY 2010-11. The petitioner has requested that UFG @ 6% be allowed for FY 2005-06.
- 4.1.2 The petitioner contended that internationally UFG level of 1%-3%, 3%-6% & over 6% are accepted as low, reasonable & excessive, respectively. Further, this level related to developed countries and was not applicable in case of Pakistan owing to totally different operating conditions.
- 4.1.3 The petitioner argued that UFG loss was an ongoing process which tended to increase with time owing to expansion and aging of the network, leading to increased leakages, aging of meters which resulted in under-recording, measurement errors, sticky / stopped meters incorrect readings etc.
- 4.1.4 The petitioner further stated that the main causes of UFG losses in transmission system included: i) receipt of gas from 23 different sources, each having different mechanisms of gas measurement with different percentages of accuracy, ii) rupture of pipelines caused by terrorist activities and iii) drainage of condensate / associated gas.
- 4.1.5 Similarly, in the case of distribution system, the petitioner pleaded that the causes for UFG losses were: i) increase in gas thefts, ii) inferior quality of



material purchased locally under Government instructions to patronize local industry and iii) third party damages leading to substantial leakages.

4.1.6 The petitioner also stated that it could not enter most industrial consumers' premises owing to inadequate availability of police protection to detect the theft of gas in the face of physical resistance by consumers. The stay orders granted by courts were another factor that hindered timely action against the culprits of gas theft.

4.1.7 The petitioner went on to say that the absence of Gas Act jeopardized its ability to take effective action against the consumers who violated the gas supply contract.

4.1.8 The petitioner requested the Authority to accord approval for application of pressure correction factor to domestic consumers. It was contended that its non-application resulted in under-recording of gas consumption leading to higher UFG level with negative effect on company's revenues.

4.1.9 The petitioner further informed that it had taken care of all controllable factors which had resulted in reduction of UFG to the maximum achievable level and contended that 6% was a reasonable level to achieve and sustain in accordance with international standards.

4.1.10 The petitioner stated that the UFG benchmarks of 5.75% & 4% had been set by the Authority without consultation, which was against clause 21 of its license.

4.2. Discussion and Decision

4.2.1 The Authority's research reveals as under:-

4.2.1.1 32 distribution companies operating in USA, reported by US Department of Transport, Office of Pipeline Safety, had suffered UFG in the year 2002 as under:-



Table 2: UFG levels of US distribution companies in the year 2002

Number of Companies	% UFG Reported
9	0 to 1
12	> 1 to 2
6	> 2 to 3
3	> 3 to 4
2	> 4 to 5

- 4.2.1.2 The above companies cover medium and large-sized industry players with more than 500,000 consumers and the largest of them has about 4 million consumers.
- 4.2.1.3 Victorian Energy Network Corporation of Australia has reported that UFG level for an integrated company in Australia is between 1.9% to 3%.
- 4.2.1.4 UFG in local distribution zones in UK is estimated at 0.7% of their throughput.
- 4.2.1.5 It is evident from the above data that the petitioner's contention that internationally UFG level between 3%-6% is reasonable for an integrated company is not tenable. On the contrary, it leads to the inescapable conclusion that internationally acceptable UFG level is less than 3%.
- 4.2.1.6 In view of the above, the Authority's proposal for reducing UFG progressively to 4% level is reasonable even after taking the local operating conditions including socio-economic patterns into account.
- 4.2.1.7 The petitioner has taken the plea of poor quality of local materials, which it is stated that they have to patronize under Government policy. This plea is not based on facts because the Government has never advised to procure sub-standard materials from the local industry. It is petitioner's responsibility to ensure procurement of materials of standard specifications.



- 4.2.1.8 The argument of aging network is also not sustainable. As far as the Authority is concerned, it has been allowing expenditure on system augmentation and repair & maintenance of gas pipelines as demanded and if the size or quality of this work has not been adequate, the responsibility lies squarely on the petitioner's shoulders.
- 4.2.1.9 The petitioners' plea of applying pressure factor in the case of domestic consumers raises quite a few questions. It has not discussed the impact of temperature correction factor, the design of gas meters in use, international best practices etc. This issue will be dealt by the Authority separately if a proper petition is submitted and not as part of the review motion in hand.
- 4.2.1.10 The Authority observes that after extensive consultation with the petitioner on the introduction of UFG targets, in its determination dated August 08, 2002 for FY 2001-02, it had directed the petitioner to reduce the UFG progressively to less than 6% by the end of FY 2004-05. In pursuance of this direction, UFG target for FY 2003-04 was fixed at 6.5% and for FY 2004-05 at 6%. It was expected that in these three years both the utilities would take all necessary measures to reduce the UFG e.g. controlling theft, leakages and other related factors. However, the record shows that the companies did not attach due priority to this important aspect of their work. The Authority would like to refer to the National Security Council's decision in case No. NSC-16/7/2000 dated 11-10-2000 requiring the regulators to look into the losses and inefficiencies of the public utilities before allowing them the tariff increase. It is obligatory on the part of OGRA to lead the gas utilities to gradually reduce the UFG losses through fixation of incentive oriented reasonable UFG targets.
- 4.2.1.11 Keeping in view the contentions of the two utilities about the prevailing environment in the country due to which they feel handicapped in bringing the UFG down to the international standard



of 2-3%, the Authority has reviewed the UFG benchmarks in its entirety and hereby fixes the same on a long term basis as under:

Table 3: Upper and Lower UFG Targets

Financial Year	Upper Target	Lower Target
2005-06	6.00%	5.70%
2006-07	6.00%	5.40%
2007-08	6.00%	5.10%
2008-09	5.50%	4.80%
2009-10	5.50%	4.50%
2010-11	5.00%	4.25%
2011-12	5.00%	4.00%

The above UFG targets are subject to following conditions:

- (a) UFG during a financial year above the upper target shall be fully absorbed by the licensee from its own profit without any allowance in the Revenue Requirement.
- (b) UFG during a financial year above the lower target upto the limit of upper target shall be allowed to be adjusted in the revenue requirements to the extent of 50% and balance 50% shall be absorbed by the licensee from its own profit.
- (c) If in a financial year, the licensee achieves greater efficiency and brings the UFG down to less than the lower target, it will be entitled to retain the entire benefits below the lower target.
- (d) The UFG targets shall be reviewed when the input of gas increases by 10% or more compared to the total actual volume in FY 2005-06 with a view to making appropriate adjustments on account of incremental sales.



5. HUMAN RESOURCE (HR) COST

5.1 Petitioners Grounds for Review

- 5.1.1. The petitioner requested for the withdrawal of the HR benchmark on the ground that both the bases of benchmark i.e. consumer base and gas sales volume were, to certain extent, beyond its control.
- 5.1.2. The petitioner went on to say that: (i) the number of connections provided to the domestic consumers was pre-determined by the Government, (ii) the requirement of Government's approval would impede the efforts of the company to increase the consumers, and (iii) the volume of gas sold was dependent on factors which, a great extent, were beyond the control of the petitioner, as substantial additional gas was not available.
- 5.1.3. The petitioner argued that the Authority, while setting the benchmark, did not take into account the following:
- a) Consequential impact on HR Cost of quality and performance standards prescribed by the Authority.
 - b) HR cost required to execute the GOP distribution development programmes like "Tameer-e-Watan".
 - c) Impact of inflation on medical cost and salaries.
 - d) Effect of annual increments.
 - e) Impact of impending CBA agreement effective July 01, 2005.
 - f) Impact of additional manpower for linking new areas to the system.
- 5.1.4. The petitioner also stated that the Authority had not consulted with it before introducing the HR benchmark, which was against the requirements of Section 6 (2) (b) of the OGRA Ordinance.



5.2 Discussion and Decision

- 5.2.1 If past is any guide, in a growing system as in Pakistan, both consumer base as well as volume of gas transported will continue to increase at a steady pace and consequently the HR benchmark will keep going up in monetary terms. It is noted that while the petitioner has over emphasized the negative factors, the positive ones e.g. economy of scale with increasing base and productivity gains through rationalization of human resource, improved processes and technology, training etc. have been completely omitted. The HR benchmark, based on the “actual” cost of a financial year would provide sizeable cushion as through appropriate actions to improve productivity, savings can be made and the petitioner has repeatedly claimed that it had been determinedly moving toward being a more efficient organization.
- 5.2.2 The periodic agreements with CBA and revision of executive packages are also to be designed in a manner that greater and greater link is established between compensation and productivity and average cost of operation per consumer, per K.M. of pipelines and per unit of gas sold is reduced. The HR benchmark will, on the other hand, continue to increase owing to indexation to number of consumers, length of pipeline and volume of gas transported. There is no justification for including impact of agreements with CBAs in addition to the benchmarks. Such addition, if allowed separately, will defeat the very purpose of setting up an HR benchmark.
- 5.2.3 The Authority however, feels that the petitioner’s contention of getting no adjustment at all on account of inflation merits consideration. After in-depth analysis, the Authority agrees to allow “inflation adjustment to the extent of 50% of CPI” on a year to year basis. This would be in addition to indexation to the base year i.e. actual HR cost of FY 2004-05, of increase in “number of consumers with 60% weightage”, increase in “network with 20% weightage” and “gas sales volume with 20% weightage”. The saving or excess vis-à-vis HR cost benchmark will be shared equally between the petitioner and the consumers through adjustment at the time of determination of final revenue requirement. If the actual HR cost of the petitioner is higher than the benchmark HR cost, 50% of the excess amount will be adjusted in the revenue



requirement and balance 50% shall be absorbed by the licensee from its own profits. Conversely, if the actual HR cost is less than the benchmark HR cost, 50% of the savings shall be retained by the petitioner and the balance 50% will be adjusted in the revenue requirement.

5.2.4 Having reviewed the benchmark as above, the Authority has decided to take actual cost of FY 2004-05 amounting to Rs. 3,291 million as the base figure and determines the HR benchmark for FY 2005-06 provisionally at Rs. 3,792 million (*Annexure-II*) subject to adjustment on actual result. Further, the above formula of benchmark fixation will be reviewed after the results of FY 2007-08 become available.

5.2.5 The petitioner's contention that its view point was not taken into account at the time of setting up HR benchmark for DERR 2005-06, is not correct. The Authority introduced the benchmark on experimental basis after due consultation with the petitioner and giving due consideration to views of the petitioner and the Federal Government, the principal stakeholder. Nevertheless, adjustments have now been made after further interaction in light of the relevant factors, as discussed and decided above.

6. STORES AND SPARES WRITTEN OFF

6.1. Petitioners Grounds for Review

6.1.1 The petitioner requested for allowance of expense of Rs. 50 million under this head as it had a direct bearing on measures to control UFG.

6.1.2 The petitioner explained that aging of the meters and mechanical wear & tear of the mechanical parts resulted in under-recording of consumption and non-replacement of these meters would increase UFG.

6.2. Discussion and Decision

6.2.1 The petitioner has not submitted any additional evidence in the proceedings on Review Motion. It is yet to establish that its claim for write off relates to the written down value of those meters, which had to be removed having become



irreparable before expiry of their normal life. The petitioner also needs to establish that this function is being performed in a systematic technically sound and cost effective manner.

6.2.2 The Authority maintains its earlier decision of not allowing the provision amounting to Rs. 50 million in respect of stores & spares.

7. DEFERRAL ACCOUNT

7.1. Adjustments on account of revised H. R. Cost and UFG Benchmarks have been set-off against the provision of deferral account without any revision in the prescribed prices already notified by the Authority (*Annex-I*).

8. DETERMINATION

8.1. After making the above adjustments, the estimated revenue requirement for FY 2005-06 is maintained at Rs. 93,354 million (*Annexure-III*) as determined under the Authority's Order dated May 20, 2005.

(M.H. Asif)
Member (Finance)

(Jawaid Inam)
Member Gas) /
Vice Chairman

(Munir Ahmad)
Chairman

Islamabad,
October 12, 2005