18 February 2022

Gas sector reforms

Amendments in OGRA Act should bode well for Circular debt reduction

The government has passed amendments in the OGRA Ordinance 2002; which will streamline the process of future gas determination and improve cost recovery in the gas system. Oil and Gas Regulatory Authority (OGRA) is the regulator with powers to determine petroleum and gas prices in Pakistan; however, government intervention in the past has undermined its ability to pass on the increase in cost of gas and other fuels (aimed at containing increase in prices to protect consumers). The resultant inefficiencies – from delays in determinations and inadequate cost pass-on – ultimately led to massive circular debt, a liquidity crisis in the entire Gas chain.

Both houses of Parliament have approved the amendments, which come into effect immediately. The two key amendments are:

Amendments	Implications
Cost of RLNG imports will now become part of weighted average cost of gas – of the gas distribution companies, SNGP and SSGC – instead of accounting for them separately from distribution of indigenous natural gas.	This will significantly improve cost recoveries for the Gas utilities and in turn their suppliers (E&Ps and PSO). In the past, during winters gas utilities supplied imported RLNG to domestic consumers, which were however charged at the rate of natural gas (less than half the cost of RLNG), which exacerbated circular debt buildup for the utilities and their suppliers. In our view, the amendment will spread out the cost of expensive RLNG to all consumers and improve cost recovery in the long run. However, an immediate side effect of this step will be higher inflation through the increase of consumer gas tariffs, all else the same.
OGRA will notify new gas prices without government and public intervention	This will make the process of gas determination more nimble – eradicating the time it takes the utilities to match the cost of gas with their revenues – and in turn not build upon the circular debt balance, especially in an environment of sharply rising oil prices (Gas prices in Pakistan are benchmarked to international oil prices). In the past, delays in gas determination have been as severe as 2-3 years apart.

Source: IMS Research

All in all, the above measures will not only lead to better matching of costs and revenues in the gas system (lower circular debt), but also, doing so will significantly reduce cross subsidies and ultimately the fiscal burden borne by the government. We believe that the amendments are part of the commitments made to the IMF for Program resumption. **The reform is another key milestone achieved by the PTI government aimed at eradicating the root causes of circular debt in the Energy chain. It is in line with our expectation for greater Energy sector reforms during 2022, which will lead to turnaround of payouts from companies in the Energy chain, and in turn better price discovery in Energy sector stocks, in our view.**

Key Beneficiaries

Gas Utilities: The two gas distribution companies in Pakistan – Sui Northern Gas Pipeline Ltd (SNGP) and Sui Southern Gas Company (SSGC) – will benefit from more timely gas determination and efficient cost recovery from consumers. Cash-flows will majorly improve and earnings will rise mostly because of lower finance cost on borrowings, in our view. The utilities will in turn have more internal cash-flows for investment in large pipeline projects in Pakistan, which directly enhances their profitability. UFG losses will be larger, as they are based on higher cost of gas.

E&Ps: Pakistan Petroleum Ltd's (PPL) receivables have shot from c.PKR60bn by end FY16 to c.PKR280bn by end FY21. It started from the c.60% increase in well-gas price of Sui field (PPL's largest asset which supplies c.10% of indigenous natural gas) in May 2016. Given the delays in the gas tariff determination of the Gas utilities, PPL has not been able to fully recover the increased cost of gas supplied to them. Rising share of RLNG in total gas consumption in Pakistan – without commensurate increase in consumer gas tariffs – exacerbated the issue. Thus, PPL has resorted to sharp dividend cuts and even subpar drilling activity ever since.

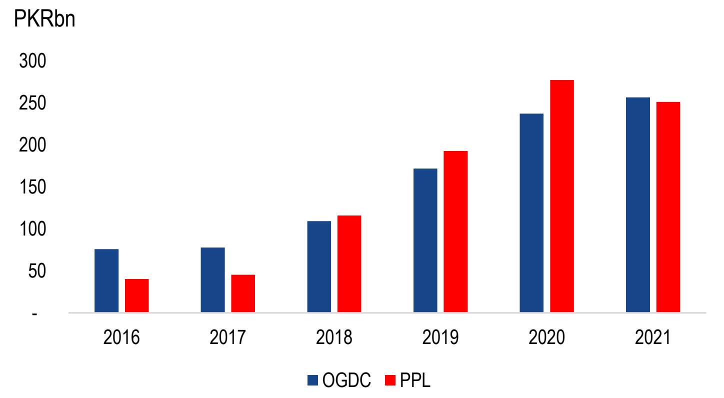
Continued on the next page…

Muhammad Saad Ali, CFA
saad.ali@imsecurities.com.pk
+92-21-37131610

IMS Research
research@imsecurities.com.pk
+92-111-467-000

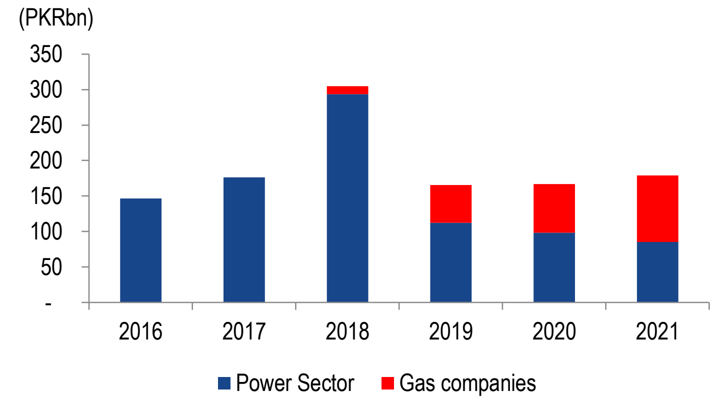
The other large E&P, Oil & Gas Development Co. (OGDC), has faced the same issue as PPL but dividend cuts in its case have been less acute. Both stocks are significantly undervalued, at forward P/E of c.3.0x earnings; the present stock prices are at the same levels as when Brent was around US$40/bbl (before November 2020).

Circular debt of E&Ps has more than quadrupled in the past 5 years



Source: Company Accounts

PSO's circular debt has shifted from the Power sector to SNGP



Source: Company Accounts

PSO: Being the largest importer of petroleum and RLNG in Pakistan, Pakistan State Oil (PSO) has long been among the worst affected companies from circular debt. Phase out of furnace oil based power generation, since late 2017, has significantly improved the company's cash-flows ever since. However, PSO has been importing LNG since 2015 and supplying it to the gas utilities. In the recent past, SNGP has been the prime source of fresh circular debt for PSO, while dues from the IPPs have progressively declined (refer chart above). The above amendments promise to slow down the buildup from gas utilities as well, in our view. This should release the company's cash-flows to invest in the upgrade of Pakistan Refinery Ltd.

Neutral for Fertilizer: Fertilizer sector is presently enjoying decent pricing power amid low inventory levels, better farm economics and significant increase of Urea prices in international market. Therefore, we believe that any increase in feed and fuel gas prices will easily be passed on to end users by the producers. If the government increases feed and fuel gas prices by PKR50/mmbtu then it will translate into c.PKR75/bag increase in Urea Prices. If government increase gas prices and simultaneously producers pass on such impact, then this event will be (i) neutral for FFC, (ii) negative for FFBL and FATIMA; as DAP and NP prices are set according to import parity and any significant decline in imported DAP prices will reduce both companies' margins, and (iii) positive for EFERT, as it is procuring additional gas at 2012 Petroleum policy rates which are significantly higher than normal Fertilizer gas rates. Hence an increase of PKR50/mmbtu in gas prices will elevate EFERT EPS by PKR0.34, all else the same.

Broadly Neutral for General industries: Given the above amendments are likely to lead to higher gas tariffs, in our view, certain Chemical companies could bear lower profit margins (especially the Petrochemicals, LOTCHEM and EPCL, which lack pricing power as prices/margins are internationally determined). The Textile sector will be neutral as their gas tariff have been fixed at US$6.5/mmtu and linked to that of regional competitors. From our understanding, other industries, which consume RLNG instead of natural gas (especially in the North), may benefit from relatively lower cost of gas. However, we await further clarity on this matter.

We, Muhammad Saad Ali, CFA and IMS Research team certify that the views expressed in the report reflect our personal views about the subject securities. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations made in this report. We further certify that we do not have any beneficial holding of the specific securities that we have recommendations on in this report.

Ratings Guide*	Criteria
Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
Sell	Expected downside of more than 5% or expected to underperform the KSE-100 index

*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks: This development can worsen inflationary outlook.

Disclaimer: Intermarket Securities Limited has produced this report for private circulation only. The information, opinions, and estimates herein are not direct at, or intended for distribution to or use by, any person or entity in any jurisdiction where doing so would be contrary to law or regulation or which would subject Intermarket Securities Limited to any additional registration or licensing requirement within such jurisdiction. The information and statistical data herein have been obtained from sources we believe to be reliable where such information has not been independently verified and we make no representation or warranty as to its accuracy, completeness, and correctness. This report makes use of forward looking statements that are based on assumptions made and information currently available to us and those are subject to certain risks and uncertainties that could cause the actual results to differ materially. No part of the compensation of the author(s) of this report is related to the specific recommendations or views contained in this report.

This report is not a solicitation or any offer to buy or sell any of the securities mentioned herein. It is meant for information purposes only and does not take into account the particular investment objectives, financial situation or needs of individual recipients. Before acting on any information in this report, you should consider whether it is suitable for your particular circumstances and, if appropriate, seek professional advice. Neither Intermarket Securities Limited nor any of its affiliates or any other person associated with the company directly or indirectly accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein.

Subject to any applicable law and regulations, Intermarket Securities Limited, its affiliates or group companies or individuals connected with Intermarket Securities Limited directly or indirectly may have used the information contained herein before publication and may have positions in, or may from time to time purchase or sell or have a material interest in any of the securities mentioned or may currently or in future have or have had a relationship with, or may provide investment banking, capital markets and/or other services to, the entities mentioned herein, their advisors and/or any other connected parties.

RESEARCH DISCLOSURES

Third Party Research

This is third party research. It was prepared by Intermarket Securities Limited (IMS), with headquarters in Karachi, Pakistan. Intermarket Securities Limited (IMS) is authorized to engage in securities activities according to its domestic legislation. Intermarket Securities Limited (IMS) has sole control over the contents of this research report.

Intermarket Securities Limited (IMS) is the employer of the research analyst(s) responsible for the content of this report and research analysts preparing this report are resident outside the U.S. and are not associated persons of any U.S. regulated broker-dealer. The analyst whose name appears in this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority ("FINRA") and, therefore, may not be subject to applicable restrictions under FINRA Rules on communications with a subject company, public appearances and trading securities held by a research analyst account.

None of the materials provided in this report may be used, reproduced, or transmitted, in any form or by any means, electronic or mechanical, including recording or the use of any information storage and retrieval system, without written permission.

Disclaimers

Investing in any non-U.S. securities or related financial instruments (including ADRs) discussed in this report may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the U.S. Securities and Exchange Commission. Information on such non-U.S. securities or related financial instruments may be limited. Foreign companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect within the United States. The value of any investment or income from any securities or related financial instruments discussed in this report denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related financial instruments.

Frontier and Emerging Market laws and regulations governing investments in securities markets may not be sufficiently developed or may be subject to inconsistent or arbitrary interpretation or application. Frontier and Emerging Market securities are often not issued in physical form and registration of ownership may not be subject to a centralized system. Registration of ownership of certain types of securities may not be subject to standardized procedures and may even be effected on an ad hoc basis. The value of investments in Frontier and Emerging Market securities may also be affected by fluctuations in available currency rates and exchange control regulations. Not all of these or other risks associated with the relevant company, market or instrument which are the subject matter of the report are necessarily considered.

US Distribution

This Report is considered independent third-party research and was prepared by **Intermarket Securities Limited (FBD)**, with headquarters in **Pakistan**. The distribution of this Research is provided pursuant to the exemption under Rule 15a-6(a)(2) and is only intended for an audience of Major U.S. Institutional Investors (MUSIIs) as defined by Rule 15a-6(b)(4). This research is not a product of **StoneX Financial Inc.**. **Intermarket Securities Limited** has sole control over the contents of this research report. **StoneX Financial Inc.** does not exercise any control over the contents of, or the views expressed in, any research reports prepared by **Intermarket Securities Limited** and under Rule 15a-6(a)(3), any U.S. recipient of this research report wishing to effect any transaction to buy or sell securities or related financial instruments based on the information provided in this research report should do so only through **StoneX Financial Inc.** For any information, please contact Gene Turok. Under no circumstances should any U.S. recipient of this research report effect any transaction to buy or sell securities or related financial instruments through **Intermarket Securities Limited.**

Intermarket Securities Limited (IMS) is not registered as a broker-dealer in the United States and, therefore, is not subject to U.S. rules regarding the preparation of research reports and the independence of research analysts. This research report is provided for distribution to "major U.S. institutional investors" and other "U.S. institutional investors" in reliance on the exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act").

Distribution outside US

This report is not intended for distribution to the public and may not be reproduced, redistributed or published, in whole or in part, for any purpose without the written permission of Tellimer. Tellimer shall accept no liability whatsoever for the actions of third parties in this respect. This report is for distribution only under such circumstances as may be permitted by applicable law.

This report may not be used to create any financial instruments or products or any indices. Neither Tellimer, nor its members, directors, representatives, or employees accept any liability for any direct or consequential loss or damage arising out of the use of all or any part of the information herein.

United Kingdom: Distributed by Exotix Partners LLP only to Eligible Counterparties or Professional Clients (as defined in the FCA Handbook). The information herein does not apply to, and should not be relied upon by, Retail Clients (as defined in the FCA Handbook); neither the FCA's protection rules nor compensation scheme may be applied.

UAE: Distributed in the Dubai International Financial Centre by Exotix Partners LLP (Dubai) which is regulated by the Dubai Financial Services Authority ("DFSA"). Material is intended only for persons who meet the criteria for Professional Clients under the Rules of the DFSA and no other person should act upon it.

Other distribution: The distribution of this report in other jurisdictions may be restricted by law and persons into whose possession this document comes should inform themselves about, and observe, any such restriction