Trying to link gas prices to market prices is ironic since this is precisely the freedom that was originally offered

What's difficult to understand is why gas prices are controlled by a formula when oil sales are linked to international prices -- which means it is RIL's bad luck it found gas instead of oil!

Ever since gas production at Reliance Industries Ltd's (RIL) Krishna Godavari (KG) Basin fields started falling in FY12—from 55.9 mmscmd in FY11 to 42.77 mmscmd in FY12—the belief has been that RIL is deliberately suppressing production so that, when the government hiked prices after the five-year validity of the initial price expired, it could gain from higher prices. Which is probably why, on July 4, the finance ministry issued an office memorandum asking for examination of the possibility that RIL be asked to make good its earlier gas commitment even after prices are hiked—after all, the ministry reasoned, RIL's production had fallen due to technical difficulties and since the government had cleared the company's $10 billion capex on the basis of the higher gas production, it was entitled to get the gas at the old price.

RIL, in turn, has rubbished this hypothesis of it suppressing production, and by that logic the finance ministry's case for asking it to make good the 'loss' in production—128 mmscmd till FY14. RIL's argument is that once production fell, the government cut off the gas supplies from the KG Basin fields to its petrochemicals plant. It then had to import 10-15 mmscmd of gas since FY12 at an average price of $16 per mmBtu versus the $4.2 it was paying for gas supplies from its KG Basin fields. RIL would obviously gain more from the doubling of prices but why would, the argument goes, the company risk its P&L for years for an uncertain hike in the future? After all, despite spending $21 billion (including the interest cost on capex) on exploration and development so far, RIL has got back just $9.2 billion, meaning the company is still years away from breaking even. This also includes $3.5 billion invested in exploring and finding nothing in 30 fields before it struck gold in the D1, D3 and MA1 blocks in KG-D6. RIL has plans to spend another $16 billion, including the interest costs on capital, to find what it thinks could be 3-4 tcf of gas—but none of this, the company is clear, is viable at even $7 per mmBtu.

Even if you dismiss RIL's argument, what's not clear is why no one in the government—not just in the petroleum ministry—ever thought of getting in global reservoir experts to verify RIL's claims. After all, experts can examine the reservoir data to see if there is a genuine problem with the reservoir or not. The cost, at the most, would have been a few million dollars. Indeed, this should still be done to set the controversy at rest—even ONGC and other Indian reservoir experts can be brought in. Indeed, the gold-plating allegation also needs to be put at rest with international benchmarking with similar deepwater block costs.

But leave that be for the moment, the other question is whether RIL should in fact have been given a higher price—based on the petroleum ministry press release, the Rangarajan formula cleared by the Cabinet results in a $6.83 per mmBtu price today, though most believe, without any reason, that the formula will yield a price of $8.4 per mmBtu by April 1, 2014, the date by which it becomes applicable to an RIL along with others such as ONGC and Cairn. Whether RIL's production picks up immediately, or whether it takes 3-4 years for production to come from the new fields should help answer the question of deliberately suppressing production!

The petroleum ministry has argued that even nationalised oil companies such as ONGC and OIL had indicated that fresh exploration in the deep waters was not viable below a gas price of below $7 per mmBtu, but whether we believe this—FE was the first to report ONGC's presentation to the oil secretary saying a $4.2 price made little sense—is not really relevant. What's important is that oil/gas producers always had the freedom to market their oil/gas and it is this that lured private firms into the sector. So, if the government actually goes along with the Rangarajan committee and eventually frees up pricing, it will be doing nothing but following the principle it always said applied.

The production sharing contract (PSC) is what determines how oil/gas production from the fields is to be governed. Article 21.3 of the PSC, for instance, says "the Contractor shall have freedom to market the Gas and sell its entitlement as per Government Policy for utilization of gas among different sectors." The PSC is available on the DGH's website. Okay, that's freedom to sell, but what about the price at which this is to be sold—after all, if the price is kept too low, and that was the fear in the RIL agreement to sell gas to the ADAG group, the government's share of profits reduces. Other clauses in the PSC deal with this. Article 21.6 on "valuation of natural gas" is the one to examine.

Clause 21.6.1 says, “the Contractor shall endeavour to sell all Natural Gas produced and saved from the Contract Area at arms-length prices”. Article 21.6.2(c) says “Gas … shall be valued on the basis of competitive arms length sales in the region for similar sales under similar conditions.” So, the real issue that concerns the PSC is about determining whether pricing is being done in collusion, nothing else.

In the case where arm’s-length pricing is not possible, clause 21.7 says “Government shall take into account amongst other relevant considerations, the domestic and international prices of comparable gas and the linkages with traded liquid fuels.” The Rangarajan report, then, isn’t actually bestowing any new rights/favours; it is merely trying to give back producers the rights that are already theirs.

Indeed, what’s even more curious in the entire episode is that those firms producing oil, and this includes RIL which produces about 14,000 bpd of oil a year, get paid at the international price even though retail customers got R1.61 lakh crore of subsidies in FY13. If oil can be priced at global prices and if India is importing 12 million tonnes of LNG at $12-15 per mmBtu, why shouldn’t domestic gas prices be freed up?

The answer is a simple one: power and fertiliser prices will shoot up if this happens. This is not really a gas producer’s problem though it is true that if you free up one end of a pipe (by freeing up gas prices) but keep the other end closed (by controlling fertiliser/power tariffs), the pipe will burst. This is where FE’s original solution comes into play: use the extra revenues the government gets from higher gas prices—an extra $4 per mmBtu, for instance, raises government revenues by R10,000 crore, versus R9,000 crore more of costs for fertilisers—to subsidise the end-user industries and, to the extent this doesn’t cover things, raise prices a bit. Let’s keep in mind the alternative to $6.4-8.4 gas prices is not more gas at $4.2 but imported LNG at $12-14 at the minimum.