Shell Companies in India

(102)

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Chairman

24 November 2008

The Secretary
Petroleum & Natural Gas Regulatory Board
1st Floor, World Trade Centre
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Sub: Draft Regulations on "Fostering Fair Trade and Competition amongst entities by Sharing of Infrastructure"

Dear Sir,

We have reviewed the draft regulations titled "Petroleum and Natural Gas Regulatory Board (Fostering Fair Trade and Competition amongst entities by Sharing of Infrastructure) Regulations, 2008" (the "Regulations") and we have the following comments to offer. At the outset, we are grateful for this opportunity to provide comments which we expect will be given due consideration before finalizing the Regulations, should the Petroleum and Natural Gas Regulatory Board (the "Board") decide to proceed with these.

Our specific observation relates to an apparent inconsistency as far as LNG terminals are concerned. While the main text of the Regulations is consistent with the provisions of the Petroleum & Natural Gas Regulatory Board Act 2006 ("the Act"), in that LNG terminals are not included in clause 2(f) in the definition of "Infrastructure" and in clause 4 on "Applicability". However, within clause 2 of Schedule A "Explanatory Memorandum" we have noted that LNG terminals have been added to an indicative listing of infrastructure facilities. "LNG terminal" is not a defined term under the Regulations, while *'liquefied natural gas terminal'* is a defined term under the Act, which goes on to prescribe the Board's powers and functions with respect to such *liquefied natural gas terminals* within Sections 11(b)(ii), 14(1) (a) (ii), 15, 18 and 47. We do not believe that the Board intends to expand its powers beyond what is mandated by legislature through the Act, and so it would appear that this inconsistency has been introduced inadvertently. We would suggest that this be corrected by deletion of the reference to LNG terminal in the "Explanatory Memorandum". However, if the intention were to include LNG regasification terminals within the scope of the Regulations, we would emphasise that it would be most inappropriate to equate a key gas production facility with other storage facilities under the "Infrastructure" category.

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LNG regasification terminals are essentially facilities for natural gas production and such activity has, per the Act, been excluded from regulatory remit, except for the need for registration of entities desirous of establishing and operating *liquefied natural gas terminals* after the date the Board is established. Whilst we have dealt with the issue in more detail in the attached note, a few key points are summarized below:

a) The preamble to the Act sets out the scope of the regulatory remit to include refining, processing, storage, transportation, distribution, marketing and sale of petroleum, petroleum products and natural gas **excluding** production of crude oil and natural gas.

b) Sections 11(b)(ii), 14(1) (a) (ii), 15 and 18 of the Act prescribe the process for registration of entities desirous of establishing and operating *liquefied natural gas terminals* after the date the Board is established. It is clear that, entities which have established or are operating *liquefied natural gas terminals* before such date are exempted from such registration requirements, which indicates that the Act does not intend the Board to involve itself in such entities.

c) Explanation II under Section 63 of the Act exhaustively lists the facilities that the Act considers "infrastructure facilities" even for the limited purpose of the Section and *"liquefied natural gas terminals"* or for that matter any other gas facility is not included.

India is not the only country that views LNG regasification terminals as gas production/upstream facilities. We can cite instances from other jurisdictions where an import terminal is considered as representing another source of upstream supply.

For instance, in its Hackberry Decision of 2002[1] the FERC (USA) made clear its decision not to require third-party access to the Hackberry terminal. This decision was based in part on a view that the sales of gas would be made in competition with other sales of natural gas produced in the Gulf Coast region.

Moreover, in Europe, the standard competition test – first developed by Ofgem in UK– now used by regulatory authorities when considering a Third Party Access ("TPA ") Exemption under Article 22 of the Second Gas Directive considers the market to made up of the following: upstream supplies; the wholesale market; and the retail market. Importantly, deliveries from LNG import terminals are considered alongside other upstream sources of supply.

It is noticeable that in doing so the US and Europe, especially UK, has seen investment in a number of import terminals. Such investment in LNG regasification terminals has come about because of the enabling regulatory environment and it is important to note that the investment risk is borne by the investors and **not** consumers.

However, the risk of having a mandatory requirement to offer access to non-monopoly infrastructure to others in exchange for a monopoly infrastructure rate of return would drive away potential non-Transmission System Operators ("TSO") investors. In view of the fact that India has large unmet demand for natural gas that current or projected supplies cannot meet, we would urge the Board to consider this point.

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1 FEDERAL ENERGY REGULATORY COMMISSION, Docket No CP02-374-000, et al, December 18, 2002

A close examination of the Act clearly indicates that the intention has been to essentially encourage TPA to natural monopolies like transmission pipelines and local gas distribution systems through regulation. This is also borne out by the notified policy document of the Government of India titled "Policy for Development of Natural Gas Pipelines and City or Local Natural Gas Distribution Networks". Bringing LNG regasification terminals within the definition of contract/common carriers as defined in the Act would require a change in the Act and Policy, which does not seem to be under consideration.

By way of contrast, it would be informative to compare the Board's proposed approach with that adopted by regulatory authorities elsewhere. In particular, it would be useful to consider how the EU has addressed these issues.

Under EU legislation[2] there are provisions that allow developers of import terminals (along with other infrastructure such as storage facilities and interconnectors) to, providing certain criteria are met, apply for an exemption from having to offer TPA. In such circumstances, the developer is then able to enter into long-term contracts to underpin the investment risk and earn a rate of return commensurate with the investment.

The broad policy drivers behind such arrangements were the need to encourage merchant investment in infrastructure that was not, by its very nature, a monopoly and to encourage competition. The alternative would have been a reliance on TSO investment that would ultimately have to be guaranteed by consumers; it is important to note that with respect to exempt-infrastructure, it is the developer that bears all the investment risk.

Great Britain ("GB") took the lead in implementing this Directive. In doing so, the authorities in GB commented that:

The underlying objective is to promote competition, efficient trade and security of supply by facilitating investment in new import infrastructure[3].

In the five years since the GB authorities made the above comment, GB alone has seen the TPA Exemptions conditions used to help underpin investment in: the import terminals at Isle of Grain, South Hook and Dragon, with others planned; the BBL interconnector; and a number of storage facilities.

It is certainly the case that in comparison with other EU Member States GB was faster to implement and use the TPA Exemption provisions of the Directive. This was probably due to a combination of factors such as infrastructure need and a more market-orientated outlook when considering facilities for which there is a contestable market. However, it is equally true that other EU Member States have increasingly started to use the TPA Exemption provisions of the Second Gas Directive as a means of attracting investment. For instance, The Netherlands and Italy have approved TPA Exemption applications[3].

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2 EU Directive 2003/55/EC (repealing Directive 98/30/EC) and Regulation 1775/2005

3 Public consultation on the regulation principles of LNG terminals, CRE, 22 July 2008

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The Regulations proposed by the Board, therefore, should be seen within the context of their likely impact on the competition to attract investment.

We would like to conclude our specific observation by reiterating that the reference to LNG terminals in the draft regulations is inappropriate, for reasons mentioned above, and may be kindly removed to avoid confusion and misunderstanding on this matter.

From a broader perspective, we find it unusual that while most of the policies of the Government are aimed at encouraging investment, particularly in infrastructure, the Board has chosen to actually disincentivise new investments, and that too in infrastructure, through the Regulations. We would urge the Board to reconsider issuing the Regulations, as the immediate effect would be to put the brakes on new investment in infrastructure with entities preferring to gain access to the facilities of others rather than create their own. Sharing of infrastructure that is of mutual benefit is likely to be voluntary, and coercive sharing is likely to be contested hard on both sides that would eventually consume tremendous time and resources on all sides trying to resolve the issue. Our additional concern is that, in the face of likely activity in this area, unless adequately resourced, the Board may find it difficult to address the priorities identified for it by the Act.

Furthermore, while the preamble to the Regulation cites the provisions of the Act that allows the Board to exercise the powers to issue the Regulations, we anticipate that such an expansive interpretation of the cited references may be contested. We provide below some reasons, which in our view, could provide the basis for such contest. A more detailed analysis is provided in the attached note.

a) The preamble to the Act enjoins the Board to protect the interests of consumers and entities engaged in **specified activities** relating to petroleum, petroleum products and natural gas. Section 11 (e) actually specifies the activities (viz. common and contract carrier pipelines and city or local natural gas distribution network) where the Board is required to ensure fair trade and competition amongst entities and specify pipeline access code. The basis of expansion of the scope of the specified activities as outlined in the Regulations is not evident from the Act.

b) Under Section 11 (a) the Act requires the Board to protect the interests of consumers by fostering fair trade and competition amongst entities. The Regulations do not explain how the Regulations set out to meet this objective. It may be argued that these Regulations may end up achieving exactly the opposite outcome – with investors unwilling to invest in infrastructure, investors being unfairly treated by not rewarding them anything more than a regulated return while forcing them to yield capacity to competitors and actually providing an unfair advantage to non-investor entities who will get to use competitor's infrastructure without putting any capital at risk. This will actually reduce competition and eventually consumers' interests will suffer.

c) Section 61(2) essentially lists the areas in which the Board may make regulations consistent with the Act and 61(2)(a) –(z) makes reference to the specific Sections in the Act that call for such regulations. Section 61 (2)(za) is a residuary section that does not confer the Board the power to make regulations within the ambit of Section 11(a).

Enacting the Regulations and subjecting LNG terminals like the Hazira LNG terminal to TPA also falls foul of promissory estoppel. The shareholders of Hazira LNG Private Limited ("HLPL") developed the Hazira project on the premise of the policy of the Government of India that existing *liquefied natural gas terminals* would not be subject to third party open access. On the basis of the then existing policy of the Government of India the shareholders of HLPL invested approximately US$ 700 million to set up the Hazira LNG import and regasification terminal and to operate it by employing a flexible business model - implying an ability to handle spot as well as term LNG supply from multiple supply points as against a dedicated terminal used by defined supply points for identified customers. If the Regulations are enacted, apart from being in contravention of principles of promissory estoppel, it would also put constraints on HLPL to utilise the *liquefied natural gas terminal* as per the business model it has adopted to effectively compete in the marketplace. The Hazira LNG facility represents the largest Foreign Direct Investment in the energy sector in India and any regulatory overreach could be interpreted by the global investing community to be an instance of creeping expropriation and the impact of such an impression cannot be taken lightly.

We trust that we have been comprehensive in our response, but should you consider further elaboration necessary through further discussion or correspondence, we remain available. Our experience in working in many countries has provided us insights on how such issues have been tried or implemented elsewhere and we would be very pleased to share such information with you, if there is interest.

Yours faithfully,

Vikram Singh Mehta

Chairman

Enclosure

Legal issues relating to Petroleum and Natural Gas Regulatory Board (Fostering Fair Trade and Competition amongst entities by Sharing of Infrastructure) Regulations, 2008

The purpose of this note is to examine the context of the draft regulations from a legal perspective (a) to establish whether there is a robust legal foundation for such regulations and (b) point out specific ambiguities and inconsistencies with legislation in respect of LNG regasification terminals.

The draft Petroleum and Natural Gas Regulatory Board (Fostering Fair Trade and Competition amongst entities by Sharing of Infrastructure) Regulations, 2008 ("**Regulations**") are sought to be enacted by the Petroleum and Natural Gas Regulatory Board ("**Board**") ostensibly under the exercise of powers conferred by section 11 (a) read with section 61(2)(za) of the Petroleum and Natural Gas Regulatory Board Act, 2006 ("**PNGRB Act**") with a view to remove or minimise any form of impediment to competition amongst entities by facilitating access to certain identified infrastructure in a non-discriminatory manner.

Legal standing of the draft regulations:

The Regulations have been enacted under Section 11 (a) read with Section 61 (2) (za).

1. Section 11(a) of PNGRB Act requires the Board to protect the interest of consumers by fostering fair trade and competition amongst the entities. The provisions of protecting interests of consumers by fostering fair trade and competition amongst entities cannot and is not an all encompassing clause which allows the Board to formulate any rules that it in its discretion considers to be able to foster fair trade and competition between entities. Such rules will have to be consistent with the general principles and policy of competition law and have to be based on economic analysis and market conditions and not merely on the basis of surmises and conjectures.

2. Section 61(2)(za) is a residuary Section. This Section enables the Board to make regulations on any other matter which is required to be, or may be, specified by regulations or in respect of which provision is to be or may be made by regulations which have not been specifically set out or identified in Section 61(2). However, for this Sub-Section to apply the PNGRB Act should have specifically granted the Board the authority to enact regulations. In relation to all matters that Section 61(2) refers specific reference to enacting regulations is contained in the relevant Sections of the PNGRB Act. There is no power conferred on the Board to issue regulations in relation to matters that can be said to come within the ambit of Section 11(a). Therefore, the Regulations, have no legislative sanctity.

3. Explanation II under Section 63 of the Act exhaustively lists the facilities that the Act considers "infrastructure facilities" even for the limited purpose of the Section. Expanding the scope of third party access to infrastructure beyond this appears to be far in excess of the mandate provided under the PNGRB Act and would require a change to the PNGRB Act by the Central Government.

4. The preamble to the Act enjoins the Board to protect the interests of consumers and entities engaged in **specified activities** relating to petroleum, petroleum products and natural gas. Section 11 (e) actually specifies the activities (viz. common and contract carrier pipelines and city or local natural gas distribution network) where the Board is required to ensure fair trade and competition amongst entities

and specify pipeline access code. The basis for expansion of scope of the specified activities as outlined in the Regulations is not evident from the Act.

Ambiguity with respect to LNG Terminals

In our view, the Regulations in their current form are not meant to apply to *liquefied natural gas terminals* as the Board has, in defining "Infrastructure", kept *liquefied natural gas terminals* outside the purview and ambit of the Regulations and rightly so – maintaining consistency with the PNGRB Act. However, we have noted an inconsistency in clause 2 of Schedule A "Explanatory Memorandum" wherein a passing reference has been made to LNG terminals seeking to indicate that LNG terminals constitute infrastructure facilities to which the Regulations would be applicable. If this is inadvertent, it needs to be corrected and reference to LNG terminals requires to be deleted from the Explanatory Memorandum to the Regulations. It needs to be appreciated that any unintentional reference to LNG terminals in the Explanatory Memorandum, even though the main text of the Regulations remain silent about their applicability to LNG terminals, is likely to be misconstrued and misinterpreted and has the potential of leading to unnecessary disputes in future. However, if this is not inadvertent and has been included intentionally, then we humbly submit that inclusion of LNG terminals as infrastructure to which the Regulations would apply is seriously flawed both in scope and purview and, therefore, requires to be deleted from the Regulations for reasons that are set out below. The reasons are set out without prejudice to one another.

1. The PNGRB Act clearly limits in Section 11(e) the power of the Board to "regulate, by regulations, (i) access to a common carrier or contract carrier so as to ensure fair trade and competition amongst entities and for that purpose specify pipeline access code; (ii) transportation rates for common carrier or contract carrier; (iii) access to city or local natural distribution network so as to ensure fair trade and competition amongst entities as per pipeline access code". The PNGRB Act also clearly defines "common carrier" and "contract carrier" essentially as pipelines. Therefore, any attempt to broaden the scope of access to facilities other than those mentioned above seems to be violative of the letter and spirit of the PNGRB Act.

2. Section 63 of the PNGRB Act lays down quite unequivocally the role of the Board to monitor the transitional arrangements for sharing of infrastructure amongst oil companies under agreements reached prior to commencement of the PNGRB Act. Explanation II under the Section also specifically provides an exhaustive list of "infrastructure facilities" and LNG Terminal is not included in that list. In fact, the facilities relate to petroleum products and exclude any facilities related to natural gas. Hence, a dilated interpretation of the term "infrastructure facilities" beyond what has been comprehensively covered in the PNGRB Act seems to once again violate the letter and spirit of the PNGRB Act.

3. Section 15(1) of the PNGRB Act requires entities desirous of establishing and operating *liquefied natural gas terminals*[4] after the date of the establishment of the Board to make an application for registration to the Board. The PNGRB Act makes a distinction between existing and future entities involved in *liquefied natural gas terminals*. Existing entities involved in *liquefied natural gas terminals* are only required to

[4] liquefied natural gas terminals are defined under PNGRB Act to mean facilities and infrastructure required to: (i) receive liquefied natural gas; (ii) store liquefied natural gas; (iii) enable regasification of liquefied natural gas; and (iv) transport regasified liquefied natural gas till the outside boundaries of the facility

inform the Board about such activity within six months from the date on which the Board is established, whilst in relation to new entities involved in *liquefied natural gas terminals* the Board is expected to grant a certificate of registration after making such enquiry and subject to such terms and conditions as it may specify. Also, it may be noted that for this reason under Section 12 of the PNGRB Act the Board has neither jurisdiction to adjudicate nor receive complaints in relation to *liquefied natural gas terminals* as between the owner and operator of a *liquefied natural gas terminal* and any other entity. Furthermore, the PNGRB Act does not empower the Board to authorise or regulate access to LNG Terminals or *liquefied natural gas terminals*, as has been laid down in considerable detail for common and contract carriers (viz. multi-user pipelines and city/local gas distribution systems).

4. Having regard to the legislative scheme of the PNGRB Act, it is clear that in so far as existing *liquefied natural gas terminals* are concerned these are outside the ambit of regulatory control of the Board, except to the extent of notification requirements of informing the Board within six months of its constitution. Being outside the ambit of regulatory control of the Board, existing *liquefied natural gas terminals* have complete freedom to structure their commercial structure as well as to set tariffs and are not required to provide third party access even if the terminal is not fully utilised. However, in relation to new *liquefied natural gas terminals* the Board may probably as a condition of registration impose any restriction on such *liquefied natural gas terminals* but such conditions cannot be imposed on existing *liquefied natural gas terminals*. Therefore, any regulations that the Board may frame in relation to *liquefied natural gas terminals* can only be in relation to specifying the terms and conditions for which new *liquefied natural gas terminals* can be granted registration and none else. Also, if it is assumed (though not admitted) that the Board has the power to include *liquefied natural gas terminals* within the purview of the Regulations, such interpretation would lead to absurd results because if the entity owning and operating the facility breaches the Regulations, the Board would have no jurisdiction under Sections 12 and/or 24 of the PNGRB Act to receive any complaint or adjudicate there upon. Also, clause 7 of the Regulations which assumes adjudicatory powers for the Board is in violation of Sections 12 and 24 of the PNGRB Act as this clause 7 of the Regulations seeks to confer jurisdiction to adjudicate disputes in relation to third party open access of *liquefied natural gas terminals* when such a right has not been conferred under either Section 12 or 24 of the PNGRB Act.

5. The Regulations are in the nature of subordinate or delegated legislation. It is a settled position of law that subordinate or delegated legislation cannot transcend the limits of authority granted under the parent legislation and under no circumstances can subordinate legislation cover areas or frame subordinate or delegated legislation which is inconsistent with or against the spirit of the parent legislation. Delegated legislation under such delegated powers is ancillary and cannot, by its very nature, neither replace nor modify the parent law nor can it lay down details akin to substantive law. Legislation is an inherent and inalienable right of the legislature and this power cannot be usurped nor transgressed under the guise of subordinate legislation.

   Having regard to the above principles of law, if the Regulations seek to bring within its ambit *liquefied natural gas terminals*, it would mean that principles of third party open access, that are applicable only to gas pipelines pursuant to the PNGRB Act, have in essence been imposed on *liquefied natural gas terminals* by the exercise of subordinate or delegated legislation. Such delegated legislation is not permissible particularly so when the scheme of the PNGRB Act clearly makes a distinction between gas pipelines and *liquefied natural gas terminals*. Had the intention of the legislature been to apply third party open access on *liquefied natural gas terminals*, such principles would have been set out in the PNGRB Act as in the case of gas pipelines. Even when the Petroleum Regulatory Board Bill, 2002 was being debated in the

legislation and has in a sense usurped or transgressed under the guise of subordinate legislation the powers of the legislature. There are instances where pieces of subordinate legislation, which tended to replace or modify the provisions of the basic law or attempted to lay down new law by themselves, have been struck down by courts as *ultra vires*.

1. Sections 11 and 12 of the PNGRB Act clearly lays down the powers and functions of the Board in relation to the various assets that it has been given jurisdiction and power to regulate. Parliament in its wisdom conferred only the power of registration requirements on the Board in relation to *liquefied natural gas terminals*. As opposed to *liquefied natural gas terminals*, gas pipelines and notified petroleum, petroleum products and natural gas the Board was conferred *inter alia* with authorization powers and power of declaration of pipelines as common carrier and contract carrier and fixing pipeline tariffs etc. Section 11 and 12 of the PNGRB Act contains an exhaustive list of functions and powers of the Board, and the Board cannot exercise any powers or carry out functions that are not specifically set out in Section 11 of the PNGRB Act, unless the Central Government specifically confers any additional powers under Section 11(j) of the PNGRB Act Board. The Regulations in so far as they seek to bring within its ambit *liquefied natural gas terminals* (and in particular existing *liquefied natural gas terminals*) is flawed in as much as such an attempt would be ultra vires the PNGRB Act and beyond the powers and functions conferred by Sections 11 and 12 of the PNGRB Act and therefore liable to be struck down.

2. Under Clause 4 the Regulations apply to an entity engaged in the refining, processing, storage, transportation, distribution, marketing and sale of petroleum, petroleum products or natural gas, whilst under the Explanatory Memorandum the purpose of the Regulations is for promoting access to infrastructure facilities in oil and gas sector including LNG terminals. There is therefore an inherent conflict between Clause 4 of the Regulations and the Explanatory Memorandum by including reference to LNG Terminals if this is intended to imply *liquefied natural gas terminals*. The definition of *liquefied natural gas terminals* in Section 2(t) of the PNGRB Act means facilities and infrastructure required to: (i) receive liquefied natural gas; (ii) store liquefied natural gas; (iii) enable regasification of liquefied natural gas; and (iv) transport regasified liquefied natural gas till the outside boundaries of the facility. For this reason also the Regulations cannot be made applicable to *liquefied natural gas terminals* because *liquefied natural gas terminals* are integrated facilities and infrastructure other than storage e.g. infrastructure for receiving liquefied natural gas and regasification thereafter are not contained in Clause 4 of the Regulations. In any case one element of the storage infrastructure (that is essentially an intermediate storage – and, by way of example, can be compared to within the fence process storage in refineries) cannot be looked into in isolation and regulations imposed on the other infrastructure which when taken together constitutes an integrated *liquefied natural gas terminal*. In the current context, it is not possible to operate a *liquefied natural gas terminal* without having infrastructure for receiving and regasification.

3. The provisions of Section 11(a) have to be read together with the other provisions of the PNGRB Act and not in isolation. Therefore, in relation to infrastructure required for refining, processing, storage, transportation, distribution, marketing and sale of notified petroleum, petroleum products or natural gas the Regulations are somewhat relevant in as much as Section 11 (a) read with Section 11 (f) and other

related Sections of the PNGRB Act brings about the desired result of fostering fair trade and competition in respect of which the Board has the responsibility to (i) ensure adequate availability; (ii) ensure display of information about the maximum retail prices fixed by the entity for consumers at retail outlets; (iii) monitor prices and take corrective measures to prevent restrictive trade practice by the entities; (iv) secure equitable distribution for petroleum and petroleum products; (v) provide, by regulations, and enforce, retail service obligations for retail outlets and marketing service obligations for entities; and (vi) monitor transportation rates and take corrective action to prevent restrictive trade practice by the entities. However, Section 11 (a) which when read with the Sections 14, 15, 18 and 47 which deal with *liquefied natural gas terminals* cannot be said to confer power upon the Board to formulate subordinate legislation as in the nature contained in the Regulations because it is not understandable as to how the Regulations can foster fair trade and competition in relation to registration requirements of *liquefied natural gas terminals* contained in the PNRGB Act. Therefore, in the guise of power under Section 11(a) the Regulations seek to impose third party open access of *liquefied natural gas terminals*, which is not permissible under law.