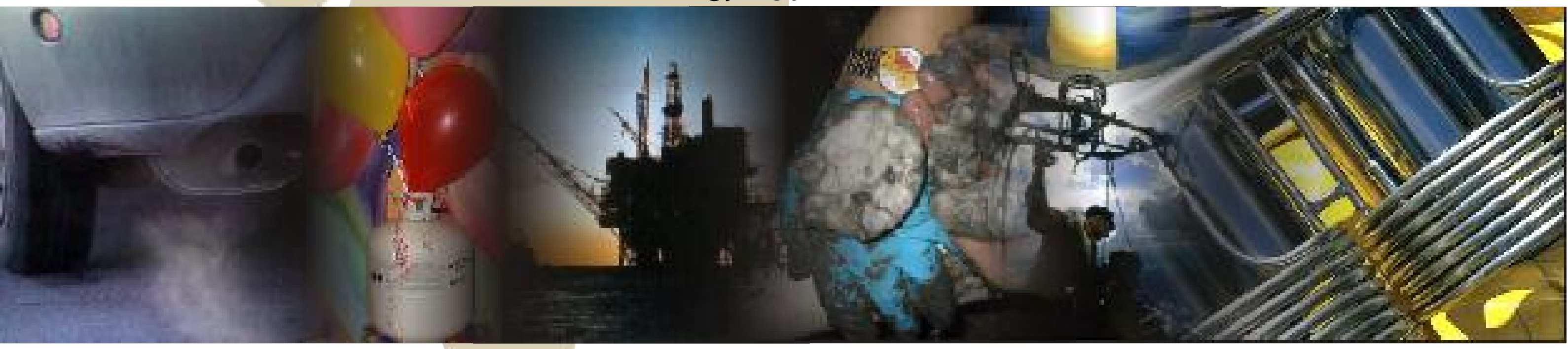
Opportunities in the Oil & Gas Sector in India



Nishith Desai Associates
Legal & Tax Counseling Worldwide

MUMBAI • SILICON VALLEY • BANGALORE • SINGAPORE

www.nishithdesai.com
nda@nishithdesai.com

Opportunities in the Oil & Gas Sector in India

-Vijay Sambamurthi
Suchir Batra

93-B MITTAL COURT, NARIMAN POINT
MUMBAI 400 021. INDIA
Tel: +91 - 22 - 6669 5000
Fax: +91 - 22 - 6669 5001

220 CALIFORNIA AVENUE, SUITE 201
PALO ALTO, CA 94306, USA
Tel: +1 - 650 - 325-7100
Fax: +1 - 650 - 325-7300

PRESTIGE LOKA, G01
7/1 BRUNTON ROAD,
BANGALORE 560 025 INDIA.
Tel: +91 - 80 - 5693 5000
Fax: +91 - 80 - 5693 5001

LEVEL 30, SIX BATTERY ROAD
SINGAPORE - 049909.
Tel: +65 - 6550 9855
Fax: +65 - 6550 9856

Nishith Desai Associates (NDA) is a research based, multi-skilled law firm based in Mumbai, Silicon Valley and Bangalore. NDA specializes in globalization of Indian corporates, information technology, international financial and tax laws, corporate and securities laws, mergers & acquisitions, media and entertainment laws and telecom laws. NDA was awarded "Indian Law Firm of the Year 2000" and "Asian Law firm of the Year (Pro-bono)-2001" by the International Financial Law Review, a Euromoney Publication. NDA has also been ranked as having a leading practice in Private Equity, Media and Entertainment and IT and telecommunications law for 2001-02 by the Global Counsel 3000.

INTRODUCTION & BACKGROUND

The history of India's oil industry dates back to 1889, when a commercially significant amount of oil was discovered in Assam, a state in the northeastern part of the country. Until 1948, the Indian Government adopted a laissez faire approach with respect to overseeing the domestic oil industry. At that point, however, the Government became involved in the industry in multiple ways, be it establishing Government-owned companies or regulating the price of oil. In 1954, under the auspices of the Geological Survey of India, the Government founded the Oil and Natural Gas Commission (ONGC). In 1959, ONGC became an oil exploration company and the Government founded Oil India Limited (OIL) as well. While ONGC and OIL addressed India's ability to extract crude oil, it had to be able to process or refine the resource after extraction. Therefore, in 1962 the Government established the Guwahati Refinery, and the India Oil Corporation Limited (IOC) was born. Of India's 17 refineries, IOC owns seven of the facilities, maintaining a 41 % market share in the refining space. IOC is a public sector company, meaning that the Government owns at least 51% of the equity capital. With respect to IOC, the Indian Government directly owns 82 % of the company, and an additional 9% is held by ONGC (which is also a public sector company), but the Government is seeking to trim its ownership to a 51 % stake through its disinvestment policy.[1]

India also had to quench the country's thirst for natural gas, and through the Gas Authority of India (GAIL), significant quantities were found offshore in numerous locations, among them Bombay High in the Arabian Sea. Natural gas is commonly used in India as fuel and to supply feedstock to fertilizer and petrochemical plants.[2] Furthermore, in the 1990s, a pipeline spanning 1,700 kilometers across India was built to transport natural gas.[3]

During the 1970s, India's domestic oil production skyrocketed, relative to its yields in the 1950s and 1960s, as over eight million tons were produced. In 1974, the ONGC made the landmark discovery, Bombay High, off India's west coast, an offshore oil field that dramatically increased the country's domestic oil production. For example, in 1989, when India's oil production peaked at 34 million tons, Bombay High's contribution was 22 million tons, or 65 % of the total.[4] This increase in oil production helped contribute to a growing sense of optimism that new oil fields with abundant supplies were just waiting to be discovered. Various offshore explorations have yielded promise in Andhra Pradesh, Tamil Nadu, Gujarat, and again, in Assam.

As a frame of reference, India's northern neighbor, China, produced 153 million tons of crude oil in 2001, compared to India's production of 32.03 million tons.[5] India imported 78.71 million tons of crude oil in 2001, which represents approximately 70%[6] of all crude oil consumed domestically. China, in comparison, imported 60.36 million tons of crude oil in 2001, and that figure increased by 15% in 2002 to 69.41 million tons.[7] It is therefore apparent that India must explore alternative avenues for energy, primarily on the domestic front.

The oil & gas sector was highly regulated until 1997, when the Government announced a policy of

1 . www.iocl.com/ioclfocus/rightcohi.htm; www.iocl.com/iocl/ioclfocus.shareholding.htm ; www.hoovers.com/co/capsule/7/0,2163,52277,00.html
2 . www.1upinfo.com/country-guide-study/india/india112.html
3 . www.1upinfo.com/country-guide-study/india/india112.html
4 . www.1upinfo.com/country-guide-study/india/india112.html
5 . www.petroleum.nic.in/ps.htm
6 . www.gasandoil.com/goc/news/nts24880.htm; www.gasandoil.com/goc/news/nts22616.htm
7 . www.chinacommercial.org/subeng/newsE021103_03.htm

deregulation of the sector. In 1976, the Oil Pricing Committee (OPC) had devised the Administered Pricing Mechanism (APM), a pricing mechanism for petroleum products that operated on the principle that the price of petroleum products should be based on the domestic cost of production, rather than on international oil prices.[8] Accordingly, refining companies were required to sell their products at Government-determined prices and were paid on a cost-plus basis by the Government. The APM was officially introduced as Government policy on December 16, 1977. The APM aimed to keep the oil &gas policy in consonance with the social welfare objectives of the Government and therefore, certain products such as kerosene and diesel were priced far cheaper in India as compared to the rest of the world. This rendered the manufacture of these products commercially unviable and the Government's impositions of minimum refining quotas for such products made the sector as a whole unviable for private sector players. Consequently, the public sector companies like IOC and GAIL enjoyed a virtual monopoly over the sector.

The Indian Government tried throughout the '80s and '90s to entice foreign investment, but Government price regulation was a seemingly insurmountable barrier to entry that foreign companies could not overcome. The lack of foreign investment stymied the exploration and production (E&P) of India's oil & gas reservoirs. Taking these factors into account, in 1997, the Government announced the deregulation of the oil & gas sector and the dismantling of the APM in a phased manner over a five-year period. The Government also introduced the New Exploration Licensing Policy (NELP). As per the NELP, foreign investors are granted the same treatment as domestic companies and it is no longer binding on them to partner with state oil companies; no blocks are reserved for national oil companies and income is free for seven years from the start of production.[9]

According to the timeline for oil price deregulation, the Government first eliminated its control over downstream (refining) oil prices. NELP then was implemented in 1999 as part of the Government's effort to deregulate upstream (crude) oil prices. Finally, the Government completely phased out the APM on April 1, 2002, when it relinquished control over kerosene and gasoline prices.

With India progressively liberalizing its economy and with the deregulation policy announced in 1997, the oil & gas sector became an interesting prospect for several private sector and foreign players. The oil & gas industry now does not require compulsory industrial licensing under the Industrial Policy of India. The sector is regulated largely by the Ministry of Petroleum & Natural Gas (Petroleum Ministry) of the Government of India. The Petroleum Ministry is responsible for the grant of licenses/leases to private and public sector companies alike, for E&P activities, for establishing refineries, for laying down crude oil and product pipelines, for the issuance of licenses for retail fuel distribution outlets, and also for the monitoring of the various projects to ensure that they conform to the applicable laws. The regulatory regime specific to the oil & gas industry

8 . www.indiainfoline.com/sect/refi/ch06.html
9. www.ciionline.org/busserv/energy/oilgas.html

constitutes primarily the Petroleum Act, 1934, the Petroleum Rules, 1974, the Petroleum & Natural Gas Rules, 1959, and the Oilfields (Regulation and Development) Act, 1948. These statutes and rules lay down the substantive and procedural requirements to be complied with in order for a private party to engage in E&P, refining, import and distribution activities relating to petroleum products. In addition, the Petroleum Ministry, from time to time, announces various notifications and regulations which govern the procedural and policy norms for the sector.

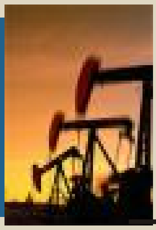
Foreign investment in any sector in India is governed by the provisions of the Foreign Exchange Management Act, 1999, the Regulations made thereunder by the Reserve Bank of India, and the Foreign Investment Policy formulated from time to time by the Ministry of Commerce and Industry of the Government of India. While petroleum refining has been brought under the “automatic route”, wherein no prior regulatory approvals are required for foreign investment up to 100% of the equity of private sector Indian companies (in case of public sector refining companies, foreign investment cannot exceed 26% of the equity of the Indian company), all other segments, such as E&P, petroleum products, pipelines, marketing and investment/financing of oil & gas projects, require the prior approval of the Foreign Investment Promotion Board (FIPB) for foreign investments. In the E&P segment, foreign investment cannot exceed 51% of the Indian company in the case of medium-sized fields, though for small-sized fields foreign investment could go up to 100%. For petroleum products and pipelines sectors, the limit on foreign investment is 51%. Foreign investment is permitted up to 100% for financing or investments in oil & gas projects with the prior approval of the FIPB. In the case of Indian companies involved in the actual trading of petroleum and petroleum products, foreign investment is permitted up to 100% of the Indian company's equity, with the condition that at least 26% of the equity be divested in favor of an Indian party within 5 years.

The Indian Government's decision to deregulate the domestic oil & gas sector and to liberalize the

FOREIGN INVESTMENT OPPORTUNITIES

foreign investment policy only serves to underscore the potential in the flurry of recent finds, predominantly in the natural gas area. In late 2002, Reliance Industries Limited (RIL), a large private sector industrial corporation with interests in the oil & gas sector, discovered seven trillion cubic feet of LNG off India's east coast.[10] Shortly thereafter, Gujarat State Petroleum Corporation (GSPC) obtained the rights provided under NELP to the gas reserves in the Krishna-Basin. Based on initial estimates the KG3 block has around 40 trillion cubic feet of gas as against the 7 trillion cubic feet of gas found by RIL. The bid for the KG3 block was made by a consortium led

10 . www.evworld.com/databases/shownews.cfm?pageid=news081102-07



by GSPC with 80 % stake. Canada-based GeoGlobal Resources Inc. and Jubilant Enpro India Ltd share the remaining equally. The 1,850 sq. km KG3 block is a shallow field that will significantly reduce the gas recovery cost.[11]

These recent discoveries bring to the forefront two of India's Achilles' heels, its reliance on naphtha and imported oil & gas, and how such weaknesses may be eliminated. With respect to naphtha, newly discovered quantities of natural gas could supplant naphtha's use as fertilizer plant feedstock, thus lowering costs and petrochemical prices.[12] Regarding oil & gas, despite India's significant production of both sources, its consumption still exceeds domestic production, thus necessitating imported oil & gas. Given current foreign exchange rates, India cannot replenish its coffers quickly enough. The recent natural gas finds, combined with the potential for other such discoveries, may curtail India's dependence on both foreign oil & gas.

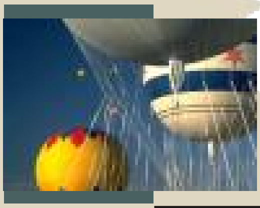
Furthermore, India's lopsided dependence on coal for energy, relative to oil and natural gas, leads to the possibility of a huge upside with respect to the recent RIL and GSPC finds. As reported by United Press International, coal produces 55 % of India's energy, while oil and natural gas make up 30.5 % and seven %, respectively.[13]

Foreign investment in India's oil and natural gas industry can occur in a myriad of ways. RIL's discovery illustrates how foreign companies can become involved in the burgeoning Indian oil and natural gas industry. According to United Press International (UPI), it is estimated that RIL will need $1.4 billion to extract and distribute the gas. That could mean opportunities for financiers, infrastructure developers and energy-industry services providers.[14] On the financial front, RIL may have to initiate a public offering, creating opportunities for companies overseas to obtain an ownership stake in RIL, a company with the most shareholders of any business in the world, 15 million.[15] This could also be a good opportunity for private equity funds investing in the energy sector to make valuable long-term investments in Indian companies in the oil & gas space. Indian Infrastructure companies are given certain exemptions from income tax and all companies that invest in infrastructure operating companies are eligible for an exemption from Indian taxation on long-term capital gains, dividends and interest income. Therefore, if structured appropriately, most investments in the oil & gas sector should be eligible for these tax exemptions. This also makes the structuring of retail securities like oil bonds a potentially attractive proposition.

On the E&P front, given that India's sedimentary area is approximately 3.14 million square kilometers, only 16 % of which had been at least moderately explored as of 1999-2000 (see graph below[16]), the door remains wide open for various foreign players to enter the Indian E&P market.

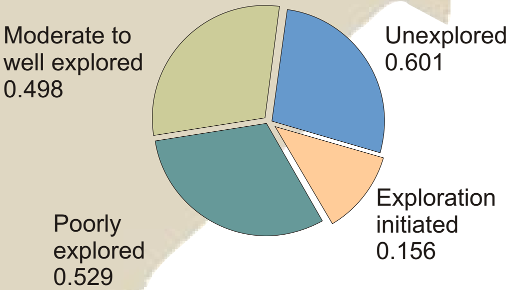
Geopolitical instability also contributes to the opportunities for foreign investment in India. As

11. www.projectsmonitor.com/index.asp?secid=40
12 . Supra n.10.
13 . ibid.
14 . ibid.
15 . ibid.
16 . www.dghindia.org/pet5.html

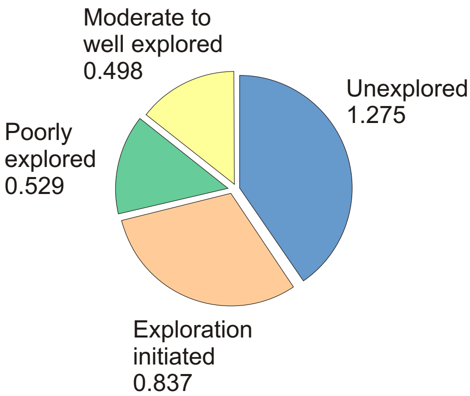


SEDIMENTARY BASINAL AREAS

(UP TO 200 M ISOBATH)



(INCLUDING DEEP WATERS)



Area (Million Sq.Km) (up to 200m iso bath)	Level of Exploration	Area (Million Sq.Km) (Inc. Deep Water)
0.601	Unexplored	1.276
0.156	Exploration Initiated	0.837
0.529	Poorly explored	0.529
0.498	Moderate to well explored	0.498
1.784	Total	3.140

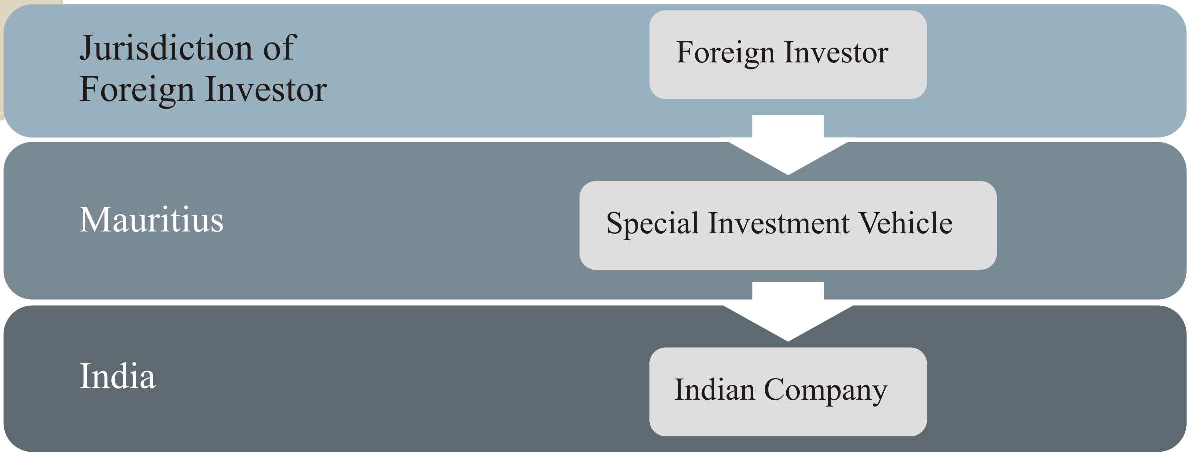
discussed earlier, India imports close to 70 % of the oil it consumes. However, 61 % of the total oil consumed comes from the Middle East.[17] Should tensions finally reach their boiling point and war erupts, India might be cut off from its dominant suppliers of foreign oil. Additionally, given the strained relations between India and Pakistan, the likelihood of completing a natural gas / oil pipeline from Central Asia to India via Pakistan remains doubtful. Although an alternative exists in a submarine pipeline, the costs remain prohibitive. Clearly, this amalgam of factors underscores the importance of India's need to develop its domestic energy sources and to attract foreign investment to spur that development.

Having taken a look at the oil & gas industry as a whole and the prevalent regulatory framework, it

17 . www.gasandoil.com/goc/news/nts22616.htm

STRUCTURING FOREIGN INVESTMENTS

would be important for foreign investors desirous of investing in the oil & gas sector in India to structure their investments in the most effective and tax-efficient manner. India has Double Taxation Avoidance Agreements (Tax Treaties) with several countries and some of these Tax Treaties provide a good opportunity to structure investments into India in a tax-efficient manner. The most popular way of investing into India has been through the use of the Mauritius route, which involves setting up a special purpose investment vehicle in Mauritius, which would then invest into the Indian company or project. Mauritius is a small island nation off the eastern coast of Africa with which India has a favorable Tax Treaty. Under the India-Mauritius Tax Treaty, all capital gains realized in India by a Mauritius resident company are exempt from taxation in India. Since Mauritius does not levy any tax on capital gains, this is a very useful way of eliminating capital gains taxes in India and Mauritius. Further, dividends received by shareholders of an Indian company are also taxable as regular income under the Indian Income Tax Act, 1961, which would entail tax at the rate of 42% for corporate investors, whereas if the Mauritius Tax Treaty benefits were available, the tax rate on dividends received would be capped at 5% (if the Mauritius company holds more than 10% of the Indian company) or 15% (if the Mauritius company holds less than 10% of the Indian company), as the case may be. The following chart depicts a typical investment structure:



For private equity funds, mutual funds, etc., which invest in oil & gas companies, several other interesting structures can be explored and implemented, depending on the considerations of each fund.

CONCLUSION

India's decision in 1997 to end 50 years of price regulation in the oil and natural gas sector was a conspicuous acknowledgment by the Government that foreign investment is necessary to further develop this industry. During the past 30 years, numerous hotbeds for oil and natural gas have been discovered in India by various companies, Government-owned or otherwise. However, despite such discoveries, India's consumption still far exceeds its production of these precious energy resources. As a result, India has grown severely dependent on foreign oil & gas, especially supplies provided by the Middle East. With geopolitical instability lurking around the corner and India's relations with Pakistan in seemingly perpetual limbo, India more than ever must work ambitiously towards discovering and developing new oil and natural gas supplies. Therefore, the influx of foreign investment, both financial and technological, is necessary and welcome, particularly with the implementation of NELP and its progeny.