**AKD RESEARCH**

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**REP-019**

PAKISTAN

OIL & GAS

**VISTA**

**Gas circular debt - Growing fatal**

**Energy chain’s circular debt has deeply marred any prospects the state owned energy com-panies have had against depleting hydrocarbon reserves/growing energy needs of the country**

**Both the Sui companies are at the frontlines of supplying 2900-3000mmcfd of gas annually to the domestic sector. Both suffer from operational inefficiencies on account of UFG losses alongside a highly regulated pricing structure set by the Govt.**

**Both the state owned E&P companies i.e. OGDC and PPL, leading to significant challenges in terms of operational activities and substandard dividend payouts (unlike MARI & POL).**

**Country’s national OMC is presently battling out working capital issues, more specifically burgeoning trade debt situation owed on account of RLNG supplies to SNGPL.**

**Implementation of the circular debt relief remains the need of the hour, either through sector overhauls or a one-off payouts through the federal revenue kitty.**

**Beat down valuations:** Energy chain’s circular debt has deeply marred any prospects the state owned energy companies have had against depleting hydrocarbon reserves/growing energy needs of the country. OGDC/PPL/PSO are the major casualties of the situation, leading the compa-nies to scale back reinvestments in projects (declining CAPEX, drilling activities etc.), undermining growth prospects and subsequent dividend cuts which in turn has led to valuation de-rating of these scrips. The gas sector circular debt, in particular, has surged over the past two years due to stagnant gas prices, increasing well-head costs, and the diversion of expensive RLNG to house-holds. Presently, the circular debt stock is around PkR1.64tn, and its burden is primarily borne by the three major fuel suppliers such as OGDCL, PPL, and PSO, with gas-based receivables on their balance sheets as of 9MFY23 amounting to PkR390bn/PkR454bn/PkR409bn, respectively.

**The gas utility menace:** Both the Sui companies are at the frontlines of supplying 2900-3000mmcfd of gas annually to the domestic sector. Both suffer from operational inefficiencies on account of UFG losses alongside a highly regulated pricing structure set by the Govt, resulting them in incurring significant GDS (gas development surcharges) backlogs on account of both indig-enous gas and RLNG distribution. Consumer and well-head gas prices continue to remain poles apart, with OGDCL’s well head presently averaging at ~PkR900/MMbtu vs. average consumer price ~PkR530/MMbtu (SSGC’s 2021 tariff). Furthermore, non-recognition of a separate RLNG tariff is an issue in itself, where-in the present revenue requirement calculations of the Sui compa-nies do not incorporate the liquefied gas. This is done while also diverting the imported gas com-modity to domestic consumers (usually in winters) on an as needed basis at uniform prices, re-sulting in the distribution utilities accumulating significant RLNG based subsidy receivables on their books. Overall, unless there is a clear policy directive to address these tariff disparities, the differential will continue to accumulate over time. With both the utility companies bending over backwards to work towards lowering their respective UFG losses, Govt. also needs to work to-wards a better gas price mechanism through ending cross subsidies (ex-fertilizers), ending tariff anomalies between southern and northern captive plants and an overall blended gas price struc-ture which includes RLNG costs (e.g. WACOG), in order to unlock the much needed cash flows of the E&P and OMC SOEs going forward.

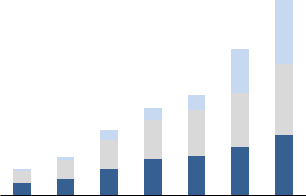
**OGDC and PPL, deep value discount amidst structural issues:** As has been widely documented, the increasing balance of circular debt has led to liquidity constraints, for both the state owned E&P companies i.e. OGDC and PPL, leading to significant challenges in terms of operational activi-ties and substandard dividend payouts (unlike MARI & POL). In FY22, both the companies drilled only 25 wells cumulatively (9MFY23: 7 wells) vs. long-term avg. of around 40/year. Furthermore, cash collections in recent years have been at an all-time low, as low as ~64%/49% of sales reve-nues in 9MFY23 vs. averaging between 90-100% since 2011 for OGDC and PPL, respectively. Over-all, in order to sustain production, the SOEs continue to invest in prospects such as gas compres-



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***SOE’s gas based receivables (PkR mn)***

1,400



1,200

1,000

800

600

400

200

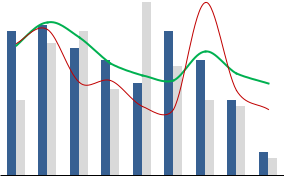
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|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| FY17 | FY18 | FY19 | FY20 | FY21 | FY22 | 9MFY23 |
|  |  | OGDC | PPL | PSO |  |  |

Source: OCAC & AKD Research

***OGDC* | *PPL - Wells drilled vs. Cash sales (%)***

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 35 |  |  |  |  |  |  |  | 140% |
| 30 |  |  |  |  |  |  |  | 120% |
| 25 |  |  |  |  |  |  |  | 100% |
| 20 |  |  |  |  |  |  |  | 80% |
| 15 |  |  |  |  |  |  |  | 60% |
| 10 |  |  |  |  |  |  |  | 40% |
| 5 |  |  |  |  |  |  |  | 20% |
| 0 |  |  |  |  |  |  |  | 0% |
| FY15 | FY16 | FY17 | FY18 | FY19 | FY20 | FY21 | FY22 | 9MFY23 |
| Wells drilled - OGDC | | |  |  |  | Wells drilled - PPL | |  |
| Cash collection - OGDC (%) -RHS | | | | |  | Cash collection - PPL (%) - RHS | | |

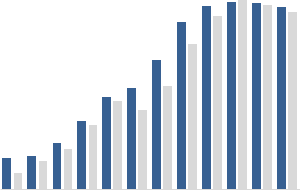


Source: OGRA & AKD Research

***OGDC* | *PPL - Receivables forecast (PkRmn)***

800,000

700,000



600,000

500,000

400,000

300,000

200,000

100,000

0

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| FY16 | FY17 | FY18 | FY19 | FY20 | FY21 | FY22 | FY23F | FY24F | FY25F | FY26F | FY27F |
|  |  |  |  | OGDC |  | PPL |  |  |  |  |  |

Source: OGRA & AKD Research



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sion projects alongside successfully bidding in high risk blocks (Zone-1). Furthermore, invest-ments in Reko Diq and PIOL, even though farfetched, may be catalysts in years to come, although not incorporated in our projections. Even then, resolution of the circular debt saga is vital for both the state owned E&P companies, due to which exploration activity has remained subdued in the recent years. We expect trade debt buildup to persist in the near term (see graph on right), before slowing down starting FY25 assuming lesser currency volatility (~7% annual depre-ciation) and diligent bi-annually gas tariffs revisions. Presently, both the companies are trading at unprecedented EV/EBITDAs of 1.73/1.33 coupled with meagre forward dividend yields of 10.5%/6.5% for FY24. Based on our projections, our target prices for Dec’23 for OGDC/PPL pres-ently stand at PkR110 and 108/sh, respectively.

The sector’s higher performer, MARI, also saw its receivables from SNGPL grow up to PkR23.4bn (vs. ~10bn in FY22) in nine months amidst recent supply increase to the utility company up to 100mmcfd compared to only 20mmcfd last year. We flag this as a risk, as reliance towards SNGPL is only going to increase going forward on account of future supply increases (Bannu West block, MARI-122H etc.). Either way, MARI remains our top pick amongst the E&P companies with a Dec’23 target price of PkR3,100/sh on the stock, offering total return of of 118% from last close.

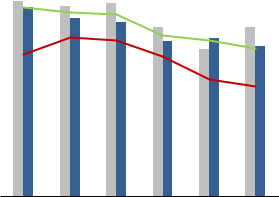
**PSO, navigating through turbulent times:** Country’s national OMC is presently battling out work-ing capital issues, more specifically burgeoning trade debt situation owed on account of RLNG supplies to SNGPL. Company’s trade debts have jumped drastically ever since the commodity super cycle hit back in 2021, prompting RLNG tariffs to go as high as ~US$18/MMbtu in May’22, resulting in gas based receivables to grow by PkR315bn in two years. Not only has this resulted in PSO borrowing heavily to finance the short fall in this rising interest rate cycle (finance costs ↑9x YoY) , it has also constrained the company’s ability to carry out operations effectively (POL im-ports/CAPEX), resulting in significant liability buildups to foreign suppliers e.g. Kuwait Petroleum (foreign trade payable: +PkR210bn b/w FY19-22). However, recent measures taken by the Govt’ (power and gas tarrif revisions) in order to meet with conditions set out by the IMF, may be a sigh of relief for the SOE energy chain overall. With another gas price revision expected post FY24 budget, we expect belligerent build-up of RLNG receivables from the gas utility company to gradually slowdown between FY24/FY25, assuming some mechanism is put forward to recognize RLNG tariffs separately or a middle ground i.e. WACOG implementation. The stock is currently trading at FY23/24F P/E of 3.3/1.7x while our TP of PkR198/sh provides a total return of 78%.

**Outlook:** Implementation of the circular debt relief remains the need of the hour, either through sector overhauls or a one-off payouts through the federal revenue kitty. More recently, Govt’ recently came forth with a proposition to address the short term liquidity needs of the energy companies, by initiating a state owned payout which was to be directed through the gas utilities towards the two E&P companies. If implemented correctly, this could provide much-needed liquidity to the companies. With regards to PSO, there is presently a proposal in works to settle the OMC’s receivables through equity transfer of Guddu and Nandipur power plants. We believe the state-owned OMC would only be transferring its woes from gas circular debt to power circular debt if it takes forth these GoP owned plants as its investments, assuming the power from these plants are to continue being sold to the country’s highly inefficient DISCO net-work. Overall, the gas/power circular debt continues to haunt the sustainability of the country’s vital energy chain and requires long-term policy measures to arrest accumulation going forward.



***OGDC* | *PPL - declining hydrocarbon production (PkRmn)***

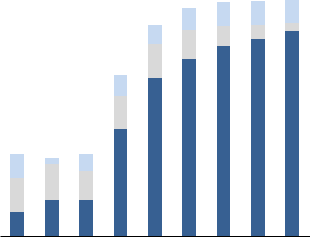
|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| 18,000 |  |  |  |  | 1,200 |  |
| 16,000 |  |  |  |  | 1,000 |  |
| 14,000 |  |  |  |  |  |
|  |  |  |  |  |  |
| 12,000 |  |  |  |  | 800 |  |
| 10,000 |  |  |  |  | 600 |  |
| 8,000 |  |  |  |  |  |
|  |  |  |  |  |  |
| 6,000 |  |  |  |  | 400 |  |
| 4,000 |  |  |  |  | 200 |  |
| 2,000 |  |  |  |  |  |
|  |  |  |  |  |  |
| 0 |  |  |  |  | 0 |  |
| FY17 | FY18 | FY19 | FY20 | FY21 | FY22 |  |
| PPL - Oil (bpd) | |  | OGDC - Oil (bpd) | | |  |
| OGDC - Gas (MMcf) - RHS | | | PPL - Gas (MMcf) - RHS | | |  |



Source: OCAC & AKD Research

***PSO: receivables breakdown (PkRmn)***

700,000



600,000

500,000

400,000

300,000

200,000

100,000

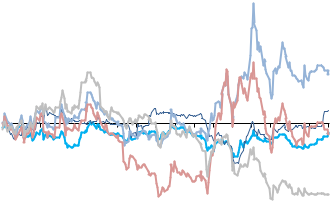
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|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| FY19 | FY20 | FY21 | FY22 | | FY23 | FY24 | FY25 | FY26 | FY27 |
|  |  | RLNG | | FO | Others | |  |  |  |

Source: OCAC & AKD Research

***MARI* | OGDC | PPL | PSO vs. KSE100 Index**

50%



40%

30%

20%

10%

0%

-10%

-20%

-30%

-40%

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| May-22Jun-22Jun-22Jul-22Aug-22 | | Aug-22Sep-22Oct-22 | | Oct-22Nov-22Dec-22Dec-22 | | | | Jan-23Feb-23 | | Mar-23Mar-23Apr-23May-23 | | |
|  | KSE100 Index |  | MARI |  |  | OGDC |  |  | PPL |  |  | PSO |

Source: PSX & AKD Research

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To arrive at our period end target prices, AKDS uses different valuation techniques including:

Discounted Cash Flow (DCF, DDM)

Relative Valuation (P/E, P/B, P/S etc.)

Equity & Asset return based methodologies (EVA, Residual Income etc.)

*New Rating Definitions*

|  |  |  |
| --- | --- | --- |
| Buy | > 30% expected total return | (Rf: 21% + Rp: 9%) |
| Neutral | > 21% to < 30% expected total return | |
| Sell | < 21% expected total return | (Rf: 21%) |

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