IS THE MERGER REALLY WORTH?

The Cabinet Committee on Economic Affairs (CCEA) has taken an in-principle decision to divest 51% of the Union Government's shareholding in Hindustan Petroleum Corporation Limited (HPCL) – a downstream Central public sector undertaking – in favour of Oil and Natural Gas Corporation (ONGC) – a PSU in the upstream segment. A Group of Ministers (GoM) under Finance Minister Arun Jaitley has been set up to work out the modalities of the merger which is expected to be completed within the current year. But is the merger really worth? ◆ **By Uttam Gupta**

The decision to merge the HPCL with the ONGC is a follow-up of the announcement by Finance Minister Arun Jaitley in his budget speech for 2017-18 to create two or three integrated oil and gas companies by merging the existing PSUs which can compete with energy majors in the private sector – both within India and abroad.

A bigger entity yields economies of scale and enhanced synergies in turn, leading to higher operational efficiency and a lower cost. It can generate a higher internal surplus which gives it the leverage to garner larger sums from investors – both as equity capital and debt. The funding of capital expenditure thus becomes that much easier enabling expansion and growth on the required scale. This is a standard argument applicable to the merger of any business.

In the said context, however, the real guiding principle is to integrate under one roof exploration and production business on the one hand and refining and retailing on the other (this is in consonance with the global practice). The former is the source of raw material, viz, crude and natural gas whereas the latter uses these for making a variety of petroleum products such as diesel, petrol, LPG, ATF and naphtha. The integration gives the unified entity enough flexibility to smoothen out the ups and downs in different segments.

When the international prices of crude and gas are declining, the businesses in the upstream segment suffer as realization from sale goes down. However, for an integrated entity this is compensated by gains in the downstream segment (lower raw material cost leads to a better refinery margin). In a reverse scenario when crude and gas prices increase, the downstream may lose (higher raw material cost squeezes the refinery margin) but there is a corresponding gain in the upstream business.

But in India, things may not work out in exactly the same way.

This is because India is heavily de-

pendent on imports, viz, 80% of its crude requirements and 35% of its natural gas needs. In this backdrop, the entity emerging out of the merger will be weighed heavily towards the downstream segment. This won't be conducive to realizing the full potential of integration. For instance, when crude and gas prices increase, even as refinery margins get squeezed, there is no commensurate benefit to the upstream segment (*courtesy*, low production).

BUILDING UP OUR OWN CAPABILITY

Our focus should, therefore, be on building up our own capability for the production of crude and gas. Whether the ONGC is enabled to do it under the subsisting structure or this could be better done post-creation of a merged entity, the key point is that it should get requisite resources for funding the much-needed exploration and development efforts (the current pace is very slow, the last major discovery by the ONGC, viz the Neelam field, was more than three decades ago in the 80s).

Will the Government's decision help in this endeavour? The normal capital expenditure requirement of the ONGC is over Rs 30,000 crore annually as against its current cash balance of only Rs 13,000 crore. So, already there is a deficit even as the balance has to be met by borrowings. In this backdrop, the manner in which the so-called merger is being contemplated will only make matters worse.

Under the proposal, the ONGC will acquire 51% shareholding of the Union Government in the HPCL for which it will have to shell out about Rs 30,000 crore. The pay-out could have been more had it not been exempt from "takeover"regulations which require the acquirer to make an open offer to minority shareholders (the SEBI will grant exemption on the ground that even after the acquisition, there won't be any change of control).

Far from helping, this will further incapacitate the ONGC in funding its capital expenditure even at the existing normal level, not to talk of spend required for a substantial increase in indigenous production. Prime Minister Modi is keen to increase the domestic production of oil to at least 30% of India's requirement by 2022 which will be defeated if the Government goes ahead with the said course.

PRIME OBJECTIVE

On close scrutiny, it turns out that the prime objective of the exercise (albeit unsaid) is to garner resources to meet the target of disinvestment for the current year (against Rs 72,500 crore, the proceeds from selling HPCL shares alone would fetch Rs 30,000 crore). In that case, the Government ought to have clearly spelt out its intent and gone in for selling the shares to the public. But taking this route involved two risks.

First, the Government was not sure whether it would be able to raise the targeted amount. Secondly, there was a risk of its losing majority control. On the other hand, under the chosen route, it has risked none. It is certain to get the desired sums and there won't be any loss of its control as the HPCL becomes a wholly owned subsidiary of the ONGC which continues to be a majority owned by the Union Government.

But then it would be preposterous to brand it as merger. A merger in the strict sense of the term would require that the HPCL and the ONGC get merged into each other to create a new entity say "X". Post-merger, the two PSUs will cease to exist as independent entities even as the shareholders of each get the shares of "X" in exchange for their existing holdings after appropriate valuations.

Having said that, the Government needs to introspect whether now is the opportune time for taking the idea (two-three integrated oil and gas companies) forward. Should it not focus at least for the next five years on equipping the ONGC and the Oil India Limited (OIL) – the other oil and gas producer – to intensify work in their core areas to bring up production to the desired level?

It should be possible to achieve this goal under the subsisting structure, more so with the Modi dispensation having freed the ONGC and the OIL from the burden of discount (from 2016-17 onward) on crude supplies to downstream oil PSUs thereby augmenting their internal resource generation capability.

After India achieves a semblance of balance between the upstream and downstream segments, it may pursue the "integrated" companies concept. ■

The entity emerging out of the merger will be weighed heavily towards the downstream segment. This won't be conducive to realizing the full potential of integration. For instance, when crude and gas prices increase, even as refinery margins get squeezed, there is no commensurate benefit to the upstream segment.

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