

Chapter 5

Legal and taxation issues arising from pooling

Introduction of any pooling mechanism would result in higher costs for existing users of domestically produced natural gas and benefit future users. It is only to be expected that this will result in a spate of court cases challenging such a move. Existing customers having long term contracts for supply of gas at lower (APM) rates may need to be compensated. Similarly, producers who have entered long term contracts for supplying gas to customers at higher rates may also demand compensation.

The primary legal issues involved are of ownership of domestic natural gas under pre-NELP and NELP contracts and the authority of Government of India to frame policies for pricing and distribution of natural gas in the country. These issues have been deliberated by courts in several cases. Two cases are important in this regard, the first being the verdict of the Supreme Court of India in the dispute regarding allocation of gas from KG Basin to Anil Ambani group's power plants, and the second being the verdict of Gujarat High Court in the petitions filed against pooling of RLNG sourced by PLL under different contracts.

5.1: Supreme Court - Civil Appeal no. 4273 of 2010 arising out of S.L.P. (C) No. 14997 of 2009 in the case Reliance Natural Resources Ltd Vs. Reliance Industries Ltd:

Several issues had been raised between Reliance Natural Resources Ltd (RNRL) and RIL including applicability of Ambani family settlement to group companies and jurisdictional issues. What concerns us is the law laid down by the Supreme Court regarding ownership of domestic gas as a natural resource and powers of the government to fix gas usage priorities, rates and customers. Answers provided to some important questions by the Court in its judgement dated 7th May, 2010 were as follows:

Ownership of gas: In a constitutional democracy like ours, the national assets belong to the people. The Government holds such natural resources in trust. Legally, therefore, the Government owns such assets for the purposes of developing them in the interests of the people. In the present case, the Government owns the gas till it reaches its ultimate consumer. Under the PSC in issue the Contractor (RIL) does not become the owner of natural gas, and there is nothing like specified physical quantities of natural gas to be shared by the Gol and the Contractor.

Proper Interpretation of the PSC: The objective of the PSC inter alia is to regulate the supply and distribution of gas. Keeping this objective in mind, Article 21 of the PSC⁵¹ must be interpreted to give the power to the Government to determine both the cost valuation and charged price of gas. It is not feasible to restrict the power of the Government in such matters of

⁵¹ Article 21 of the Production Sharing Contract deals with Natural Gas

national importance, especially when the governing contract, the PSC, also provides for it. A mechanism is provided under the PSC between the Government and the Contractor (RIL, in the present case). The PSC shall over-ride any other contractual obligation between the Contractor and any other party.

Sale of gas by contractor: Though the Contractor (RIL) has the marketing freedom to sell the product from the contract area to other consumers, this freedom is not absolute. The price at which the produce will be sold to the consumer would be subject to government's approval. The tenure of such contracts can't be such that it vitiates the development plan as approved by the government. Therefore, the agreements entered into with RNRL should fix the price, quantity and tenure in accordance with the PSC.

The parties cannot violate the policy of the Government in the form of the Gas Utilization Policy and national interests. The parties must restrict their negotiations within the conditions of the Government policy, as reflected inter alia by the Gas Utilization Policy and EGOM decisions.

Price of gas: The EGOM has already set the price of gas for the purpose of the PSC. The parties must abide by this, and other conditions placed by the Government policy.

5.2: Gujarat High Court: Gujarat State Petroleum Corpn. vs The Union Of India (UOI) and 7 Ors, Special Civil Application no. 18868 Of 2007,

PLL had a long term contract for supply of LNG with Ras Gas of Qatar. In order to revive the Ratnagiri Power Plant and also to supply gas to some new

power plants, PLL negotiated an additional contract with Ras Gas in 2007. The additional quantity of gas so obtained came at a much higher price, which would render the revival plan for Ratnagiri Power Plant unviable.

Government of India then directed that all the long term LNG sourced by PLL may be pooled and supplied at a common price. Since existing customers were required to pay a higher price for gas and new customers (mainly the public sector enterprise Ratnagiri Power Plant Ltd.) would be benefitted by the arrangement, many existing customers went to court. Writ petitions were filed in the Gujarat, Madhya Pradesh and Delhi High Courts. The Supreme Court transferred all petitions to Gujarat High Court and directed that a Division Bench may hear these petitions on a day to day basis.

The case was decided on 16.5.2008 by the Gujarat High Court. In a split verdict, one judge quashed the order for pooling of RLNG issued by Government of India while the other two judges upheld pooling directive and dismissed all petitions. The reasons given by the majority decision for dismissing the petitions and upholding the pooling instructions issued by Gol were as follows:

The impugned decision taken by Union of India dated 6th March, 2007, is a policy decision for pooling price of Regasified Liquefied Natural Gas. Union of India is competent to take this policy decision and the same is neither arbitrary, nor it is unjust, nor violative of fundamental rights, nor violative of constitutional rights nor the same is violative of statutory rights of the petitioners and the petitioners have failed to establish that they have borne the burden of increase in price of Regasified Liquefied Natural Gas without passing the same to their further consumers, hence, are not entitled to refund. For getting refund, the aforesaid aspect ought to be established by the petitioners, on the basis of evidence on record, either in the suit or in the arbitration. There is no substance in these petitions, and, therefore, all these petitions are hereby dismissed.

It was clearly held that Government of India is within its rights to take a policy decision regarding pooling of gas prices and it has jurisdiction in the matter by virtue of petroleum products being included in the Union List in the Constitution of India. Appeals against this judgement of Gujarat High Court are pending in the Supreme Court of India at present, though no interim orders have been passed.

5.3: Analysis of legal position

Natural Gas comes within the meaning of "Petroleum and Petroleum Products", occurring in Entry 53 of List 1, Seventh Schedule of the Indian Constitution. This position has been confirmed by the Hon'ble Supreme Court in Association of Natural Gas & Ors. Vs. Union of India & Ors., (2004) 4 SCC 489 (Presidential Reference Case) and most recently in Reliance Natural Resources Limited Vs. Reliance Industries Limited, (2010) 7 SCC 1, wherein the Hon'ble Supreme Court observed as under-

The constitution envisages exploration, extraction and supply of gas to be within the domain of governmental functions. It is the duty of the Union to make sure that the resources are used for the benefit of the citizens of this country. Due to shortage of funds and technical know-how, the Government has privatised such activities through the mechanism provided under production sharing contracts. Nevertheless, even if private parties are employed for such purposes, they must be accountable to the constitutional set-up.

The executive of the Union of India enjoys its constitutional powers under Article 73⁵² and Article 77(3)⁵³ in order to fulfil the objectives of

⁵² Article 73. Extent of executive power of the Union

- 1) Subject to the provisions of this Constitution, the executive power of the Union shall extend
 - a) to the matters with respect to which Parliament has power to make laws; and
 - b) to the exercise of such rights, authority and jurisdiction as are exercisable by the government of India by virtue of any treaty or agreement: Provided that the executive power referred to in sub clause (a) shall not, save as expressly provided in this constitution or in any law made by Parliament, extend in any State to matters with respect in which the Legislature of the State has also power to make laws.

.... Contd.

the Directive Principles of State Policy relating to distribution of natural gas. The framing of the "gas utilisation policy" in identifying the priority sectors, and allocating the requisite quantities in accordance with the needs of the said sectors and subjecting marketing freedom to the order of priority and guidelines framed is very much in accordance with law.

Thus, regulation of natural resources like hydrocarbon products is clearly within the domain of the Union Government of India. Pricing of natural resources like Natural Gas is the prerogative of the Government of India and no private party can insist on any specific price, more so in the absence of any relevant direction or order of any Court of law to this effect.

MoPNG's approval vide letter dated June 27, 2012 has been given to GAIL to introduce a uniform price for APM gas as well as non-APM gas and thus, create level playing field for all *Taj Trapezium Zone* industrial units alike. The Hon'ble Supreme Court in *State of Tamil Nadu vs. L. Abu Kavur Bai*, (1984) 1 SCC 515, *Tinsukia Electric Supply Company Ltd. vs. State of Assam & Ors.*, (1989) 3 SCC 709 etc. has clearly affirmed Government's role in securing and distribution of natural resources that best sub-serves the common good. Given such a position of law, MoPNG's letter dated June 27, 2012, approving Uniform Pricing Mechanism seems to be clearly in line with the established legal position, duly confirmed by Courts of law.

Supreme Court has specifically held that Regasified Liquefied Natural Gas (RLNG) is nothing but gaseous form of natural gas and therefore it is covered

2) Until otherwise provided by Parliament, a State and any officer or authority of a State may, notwithstanding anything in this article, continue to exercise in matters with respect to which Parliament has power to make laws for that State such executive power or functions as the State or officer or authority thereof could exercise immediately before the commencement of this Constitution.

⁵³ Article 77(3) The President shall make rules for the more convenient transaction of the business of the Government of India, and for the allocation among Ministers of the said business

under entry no. 53 of List I – Union List and is not covered by entry no. 25 of List II - State List which mentions *gas and gas-works* and therefore, for RLNG, Union of India is having legislative competence to enact a law. Therefore, as per Article 73 of the Constitution of India, Executive powers are extended with respect to the Regasified Liquefied Natural Gas. Thus, there is power or competence with the Union of India for taking a policy decision for Regasified Liquefied Natural Gas.

Natural Gas supplied under a pooled pricing mechanism would be fixed by weighted average of domestic and imported gas prices. Existing consumers of domestic gas would have to pay more, while future consumers of imported gas will have to pay lower rates than current international prices. In effect, pooled pricing would allow us to leverage the domestically available gas to benefit a large number of new consumers, who would have otherwise consumed RNLG/Spot RLNG at a much higher price. Since the courts have held that price can be fixed by Government, it is not going to affect the ongoing contracts which can be modified under force majeure clauses accordingly to accommodate pooled price.

5.4: Taxation issues

Several issues have been raised regarding the tax regimes being followed for natural gas / LNG in the country. Of the most important ones, the first relates to customs duty on LNG and the second relates to inclusion of natural gas in the Goods and Services Tax (GST) regime or alternatively, according natural gas the Declared Goods status.

As we have seen in chapter 2, natural gas is cheaper to import than crude oil in energy equivalent terms. It is also a cleaner fuel which contributes less to environmental pollution than crude oil. Gas is a technically good substitute for crude. In spite of these advantages, an import duty of 5% is levied at present on LNG whereas crude oil attracts zero import duty. Not only this, major crude oil products are then subsidized before distribution, in spite of the externalities involved in the form of environmental degradation. The Saumitra Chaudhuri report⁵⁴ has recommended alignment of import duties on crude oil and LNG:

Import of LNG presently attracts Basic Customs Duty of 5 per cent ad valorem. Till 25 June 2011, this was the same rate that the import of crude petroleum attracted. There is no justification to have differential tax treatments for LNG and crude petroleum. The Committee recommends that the import duty of LNG may be made identical to that of the import duty of crude petroleum, which presently is zero. If in future a non-zero import duty is levied on crude petroleum, the same rate may be made applicable to LNG."

The Mercados report⁵⁵ had suggested "declared good" status for natural gas. The Saumitra Chaudhuri committee also took into account variation in Value Added Tax (VAT) between various States in the country (from 12% to 26%) and suggested granting "declared good" status to natural gas:

Presently there is varying VAT on natural gas, including LNG, across the country. It may be advisable for the Government to treat LNG/Natural Gas as a "declared good" so that they have a common concessional rate of VAT.

It was especially emphasized that variation of VAT rates may create complications in case pooling of gas is actually carried out. Some gas could be swapped instead of being unnecessarily transported over long distances.

⁵⁴ Planning Commission, Government of India (August 2011), *Report of the Inter-Ministerial Committee on Policy for Pooling of Natural Gas Prices and Pool Operating Guidelines*

⁵⁵ Mercados Energy Markets International Pvt. Ltd. (January 2010), *Study on Common Pool Price Mechanism for Natural Gas in the country*, New Delhi, India

Taxes to be imposed in the event of swapping of gas need to be clarified before any actual decision to go for widespread pooling of gas is taken.

The Integrated Energy Policy 2006 raises several other issues apart from these two. It presupposes that appropriate pricing of various energy sources and services is needed to realize efficient choice across fuels. Taxes and subsidies should be such that producer and consumer choices as to which fuel and which technology to use are not affected by them. The policy talks of equivalence of taxes across competing fuels, environmental taxes and subsidies, consistent application of “polluter pays” or “consumer pays” principle, incentives to use more efficient modes of transport and to promote R&D efforts and removal of perverse subsidies. Relevant extracts⁵⁶ from IEP Report are given below:

The equivalence of taxes across competing fuels should be uniform with respect to energy service delivered duly adjusted for prevailing overall energy efficiency levels and any other specific externality relevant to specific fuels. This would result in the least distortion as it would take into account effective calories and the conversion efficiencies of alternate fuels.

A consistent application of the “polluter pays” principle or “consumer pays” principle should be made to attain environmental objectives at least-cost where prescribed environmental norms are either not applied consistently or not being adhered to. Methodologies need to be developed to do this consistently.

Using incentives, cross subsidies, tax breaks for public investments to maximise the more energy efficient rail freight, electrification of railways, building double decked freight trains, improved mass transportation options, R&D for efficient engines or fuel alternatives etc., could also help mitigate environmental concerns.

Taxes and subsidies to create differential pricing and achieve the above objectives run the risk of creating perverse incentives. As an example, lower taxation of diesel to boost public transport has several

⁵⁶ Planning Commission, Government of India (August 2006), *Integrated Energy Policy: Report of the Expert Committee*

negative outcomes such as adulteration, less emphasis on efficiency in road transport carriage, agricultural and off-road applications, a negative environmental impact and the spawning of diesel passenger vehicles enhancing all of the foregoing negatives. Thus care should be exercised in using taxes and subsidies.