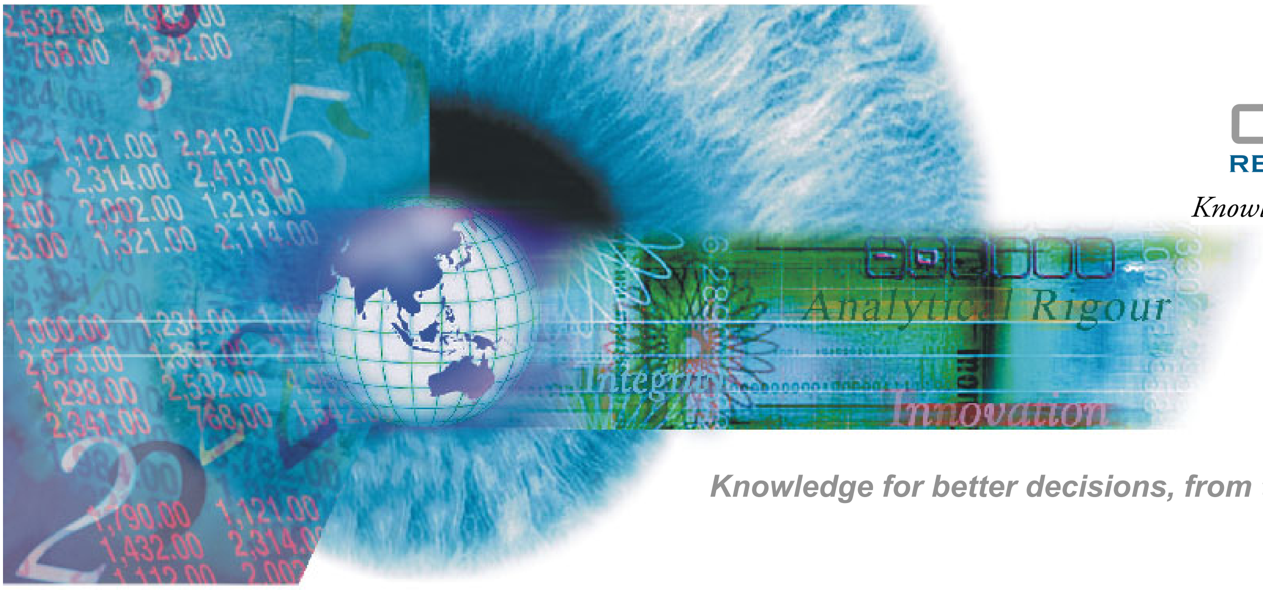

CRISIL RESEARCH

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Impact analysis: Price hike and duty cut on auto fuels

June 2006

After a lot of deliberations, the government finally increased the prices of petrol and diesel by Rs 4/litre and Rs 2/litre respectively on June 5, 2006. It has also simultaneously reduced the customs duty on these products from the exisiting 10.0 per cent to 7.5 per cent. These decisions by the government are expected to provide some reprieve to the OMCs, which were making huge losses on the marketing of these products. Although the refiners stand to lose on account of the reduction in import duties on MS and HSD, CRISIL Research expects these two decisions to have a net positive impact on the industry to the extent of Rs 81 billion.

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Price hike and duty cut on auto fuels: Although a positive for the industry, it is too little and too late

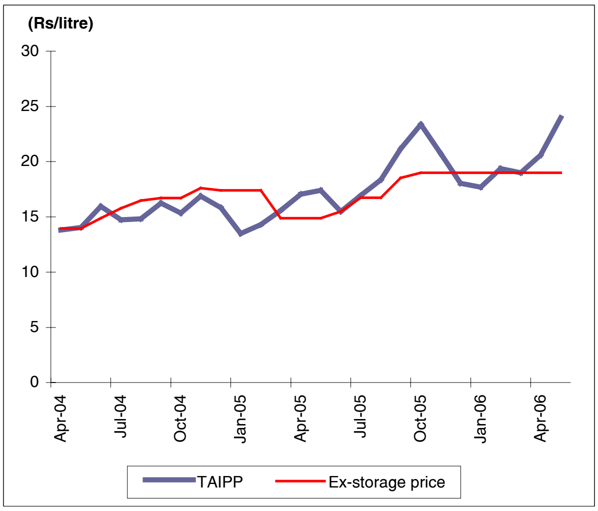
Executive summary

On June 5, 2006, the government finally gave into the pleas of the oil marketing companies (OMCs) and revised the domestic retail prices of auto fuels. The government increased the price of petrol (MS) by Rs 4 per litre and diesel (HSD) by Rs 2 per litre, with effect from June 6, 2006. The government has also reduced the customs duty on these two petroleum products from 10.0 per cent to 7.5 per cent, further reducing the tariff protection to the Indian refiners. However, it has not made the much-needed but difficult move of upward revision of domestic cooking fuel prices. This note assesses the impact of the current price hike and duty reduction on the profitability of the industry. We conclude that the marketing side of the industry stands to benefit to the extent of Rs 114.0 billion, whereas the refining side stands to lose Rs 33.6 billion due to the price hike and duty cut decisions of the government with regards to auto fuels, thereby having a net positive impact of Rs 81.0 billion on the industry.

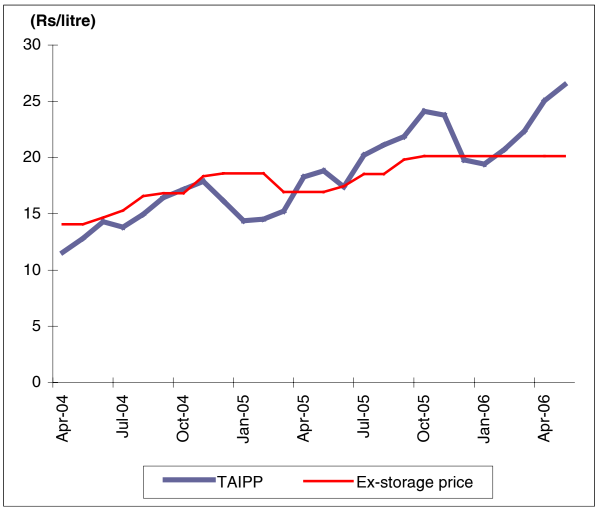
What necessitated the hike in auto fuels?

The government had previously increased the domestic retail prices of MS and HSD about 9 months back on September 5, 2005, by Rs 3 per litre and Rs 2 per litre, respectively. However, except for December 2005 and January 2006, this rise did little to help the OMCs. CRISIL Research estimates that the industry has incurred losses of Rs 71.0 billion in 2005-06 as against profits of Rs 73.5 billion in 2004-05 on the marketing of these two auto fuels.

TAIPP vs ex-storage point prices of MS



TAIPP vs ex-storage point prices for HSD



TAIPP: Tariff adjusted import parity price

Note

1) TAIPP is the price at which the OMC procures the petroleum products

2) Ex-storage point price is the selling price of the petroleum products. It has been adjusted for the marketing costs incurred on the products

Source: CRIS INFAC and Bloomberg

Since April 2006 the situation has become grim for the OMCs, as the international prices of MS and HSD have started increasing. The prices of these fuels in the international market were at their all-time highs, with HSD averaging around $81 per barrel (bbl) in April 2006 and MS averaging around $86 per bbl in May 2006. These high prices were due to high crude oil prices and persistent fears of supply shortages of these products in the international market ahead of the driving season in July (when the demand for these products is expected to be at its peak). These unusually high international prices have increased the pressure on OMCs who were already witnessing negative marketing margins on these auto fuels.

Marketing margins on auto fuels

		2004-05	2005-06	April-May 2006
MS	Rs/kl	1,006.40	(1,111.20)	(3,294.80)
HSD	Rs/kl	1,677.50	(1,567.00)	(5,630.40)
Average retail auto fuel margins	Rs/kl	1,543.28	(1,475.84)	(5,163.28)

Note

The retail auto fuel margins are calculated on a weighted average basis

Source: CRIS INFAC and Bloomberg

After considering the plight of the OMCs, the government finally agreed to increase the domestic retail prices of MS by Rs 4 per litre and HSD by Rs 2 per litre.

Import duty reduction on MS and HSD reduces tariff protection of Indian refiners but helps the cause of OMCs

The government took another step in moving from import parity pricing to trade parity pricing for petroleum products and in effect implemented one of the recommendations of the Rangarajan Committee by lowering the customs duties on MS and HSD from the existing 10.0 per cent to 7.5 per cent. However, this has further lowered the duty protection of the Indian refiners from the existing 2.1 per cent to 1.1 per cent, reducing their profitability in terms of lowering their gross refining margins (GRMs). The move is expected to cost the Indian refiners Rs 33.59 billion on account of lower realisations on the sale of these petroleum products. On the other hand, this is expected to benefit the marketing operations of the OMCs who will not have to shell this amount to procure these petroleum products.

High marketing losses on auto fuels expected to keep the industry in red in the first quarter of 2006-07

The two decisions of the government on MS and HSD are not expected to alleviate the troubles of the OMCs. The marketing margins on these retail auto fuels are expected to remain negative despite the price hike in June 2006. CRISIL Research expects the OMCs to lose Rs 3.1 per litre on MS and Rs 3.9 per litre on HSD in June 2006. Thus, the marketing losses on these two fuels in the first quarter of 2006-07 is expected to amount to Rs (59.6) billion as against a loss of Rs (15.0) billion in the corresponding period of previous year.

Although refining profits have been high in the first quarter of 2006-07, losses on the retail sales of auto fuels, coupled with the high subsidy under-recovery on cooking fuels, is expected to keep the industry in the red [excluding profits from bulk marketing sales and other businesses (pipelines etc)] for the first quarter of 2006-07.

Overall profitability of the industry

(Rs billion)	Q1 2005-06	Q1 2006-07
Net refining profits	34.46	92.18
Marketing profits on auto fuels	(15.22)	(59.67)
Under-recovery on cooking fuels	(36.48)	(55.76)
Total gross profits/(losses)	**(17.23)**	**(23.24)**

Q1: April-June

Note

1) Excludes profits on bulk marketing sales and profits from other business

2) Not adjusted for subsidy under-recovery share of upstream companies

3) Excludes MRPL and RIL's marketing profits and export sales

4) Excludes any margin on the sale of auto or cooking fuels

Source: CRIS INFAC, Bloomberg and IOG

Non-revision of domestic prices of LPG and SKO to hurt the industry even more in 2006-07

Although the government has increased the domestic retail prices of MS and HSD, and reduced their customs duty by 2.5 per cent, it has not been able to make the bold as well as the difficult move of increasing the domestic retail prices of liquefied petroleum gas (LPG) and superior kerosene oil (SKO). This is expected to higher the subsidy under-recovery burden on these products in 2006-07, adding to the woes of the OMCs.

Subsidy under-recovery burden

		2005-06	2006-07 E	Y-o-Y change (per cent)
LPG	Rs/cylinder	(142.80)	(182.23)	27.61
SKO	Rs/kl	(11.66)	(13.99)	20.00

E: Estimated; Y-o-Y: Year-on-year

Source: CRIS INFAC and Bloomberg

2006-07: Damage already done...

The high international prices of MS and HSD in the initial months of 2006-07 have worsened the marketing losses on these products for the OMCs. The increase in the domestic retail prices and decrease in the customs duty of these products are not likely to help the OMCs in earning marketing profits in 2006-07, as the marketing losses incurred by them in the first 2 months of the year on these products (especially HSD) would negate any gain that they will make on the retail sale of these products (especially MS) in the remaining 10 months.

Marketing profits on retail sale of MS and HSD

		MS	HSD	Average auto fuel margins
April-May 2006	Rs/kl	(3,290.53)	(5,628.45)	(5,160.86)
June 2006 -March 2007 (E)	Rs/kl	1,661.09	(408.43)	5.47
2006-07 (E)	Rs/kl	917.37	(1,252.10)	(818.21)
				Total marketing profits
April-May 2006	Rs/billion	(6.74)	(36.82)	(43.56)
June 2006 -March 2007 (E)	Rs/billion	19.24	(13.86)	5.38

E: Estimated

Note

The retail auto fuel margins are calculated on a weighted average basis

Source: CRIS INFAC and Bloomberg

This, coupled with the non-revision of domestic retail prices of cooking fuels, is expected to dent the industry's profitability in 2006-07.

Industry profitability on retail sale of auto and cooking fuels

(Rs billion)	2005-06	2006-07 E	Y-o-Y change (per cent)
Net refining profits	173.42	161.86	(6.67)
Marketing profits on auto fuels	(71.02)	(38.18)	n.m.
Under-recovery on cooking fuels	(192.64)	(262.64)	n.m.
Total gross profits/(losses)	(90.24)	(138.96)	n.m.

n.m: Not meaningful; Y-o-Y: Year-on-year

Note

1) Excludes profits on bulk marketing sales and profits from other business

2) Not adjusted for subsidy under-recovery share of upstream companies

3) Excludes MRPL and RIL's marketing profits and export sales

4) Excludes any margin on the sale of auto or cooking fuels

Source: CRIS INFAC and Bloomberg

However, the decisions have certainly provided some reprieve to the industry, which was otherwise staring at huge losses on the sale of auto and cooking fuels in 2006-07. In conclusion, the decisions stand to benefit the industry to the extent of Rs 81.22 billion, which will still not be enough to keep it out of the red in 2006-07.

Industry profitability on retail sale of auto and cooking fuels

(Rs billion)	2006-07 E No price hike and duty cuts	2006-07 E With price hike and duty cuts	Change in profits due to government decisions
Net refining profits	195.45	161.86	(33.59)
Marketing profits on auto fuels	(152.99)	(38.18)	114.81
Under-recovery on cooking fuels	(262.64)	(262.64)	0.00
Total gross profits/(losses)	(220.18)	(138.96)	81.22

Note

1) Excludes profits on bulk marketing sales and profits from other business

2) Not adjusted for subsidy under-recovery share of upstream companies

3) Excludes MRPL and RIL's marketing profits and export sales

4) Excludes any margin on the sale of auto or cooking fuels

Source: CRIS INFAC and Bloomberg

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