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UPDATE

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**Something is better than nothing.** We see the Government's decision to (1) increase diesel prices (₹3.5/liter net to oil marketing companies; ₹5/liter including increase in excise duty), (2) cut excise duty on gasoline by ₹5.3/liter and (3) cap the number of subsidized LPG cylinders to six per annum as a moderate positive for the Government-owned oil companies. However, the changes are in line with our expectations. We compute gross under-recoveries at ₹1.57 tn for FY2013E assuming US\$110/bbl crude oil (Dated Brent) price.

#### Savings of ₹220 bn for FY2013E under-recoveries on diesel and LPG post recent changes

The Government's decision to (1) increase retail price of diesel by ₹3.5/liter (net to oil marketing companies), (2) cut excise duty on gasoline by ₹5.3/liter to ₹9.05/liter and (3) restrict the number of subsidized cylinders to six per annum (three for the remainder of FY2013) will result in savings of ₹280 bn for FY2013E (₹220 bn excluding the savings on gasoline). Exhibit 1 gives our computations of savings in under-recoveries for FY2013E. The Government will earn an additional amount of ₹68 bn through higher excise duty on diesel, which will offset ₹60 bn of loss from reduction of excise duty on gasoline. We hope the Government is able to resist likely pressure from political parties to withdraw the announced price increases.

#### Large gross under-recoveries in FY2013E unless crude price or exchange rate moves favorably

We compute FY2013 gross under-recoveries on diesel, kerosene and LPG at ₹1.57 tn assuming US\$110/bbl (Dated Brent) crude oil price and ₹55.1/US\$ exchange rate (see Exhibit 2 for overall under-recoveries and our estimates of the likely shares of the Government, upstream and downstream companies). We estimate that FY2013E under-recoveries will be higher versus ₹1.42 tn of gross under-recoveries in FY2012 unless crude prices surprise positively. Exhibit 3 gives our computations of under-recoveries for FY2013E at various levels of crude oil price and exchange rate assumptions after incorporating the recent price changes announced by the Government.

#### Government may have to follow up with more price increases or look for more innovative solutions

The Government may have to follow up on the recent price increases with another round of price increase in 1HCY13. The election calendar is relatively light in 1HCY13 with no scheduled state elections before May 2013 (Karnataka). We like the Government's strategy to cap the number of subsidized LPG cylinders to six per household per annum (see Exhibit 4 for our computations of annual savings). It can follow a similar strategy for diesel by capping the quantum of subsidy to a certain fixed amount per liter and allowing the downstream oil companies to periodically change prices. The Government has adopted this strategy in the case of fertilizers other than urea and it has worked well so far. We had discussed some other solutions for managing the subsidy problem in our September 5, 2012 note titled '*A few innovative solutions to manage the subsidy problem*'.

#### Retain positive view on upstream names; already assume nil net under-recoveries for downstream

We see the recent price and taxation changes as providing more confidence to our earnings estimates of the upstream companies; the price increases will likely address the Street's concerns about an irrational subsidy-sharing arrangement for the upstream companies. We already assume nil net under-recoveries for the downstream oil companies. We will fine-tune our estimates for the Government-owned companies over the next few days. However, we do not expect any meaningful change to our investment view (see Exhibit 5 for target prices and valuations of the six Government-owned upstream and downstream companies) or our earnings estimates as the announcements are largely in line with our expectations.

#### QUICK NUMBERS

- ₹159 bn of savings from price hike of diesel in FY2013E
- ₹61 bn of savings from capping of LPG cylinders in FY2013E
- ₹60 bn of benefit to OMCs from excise cut on gasoline for FY2013E

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We compute total savings of ₹280 bn from the proposed changes  
Computation of savings from proposed changes (₹ bn)

	2013E (a)	2014E
<b>Savings from increase of diesel price</b>		
Diesel consumption for remaining part of the year (mn tons)	38	74
Increase in price realization for oil marketing companies (Rs/liter)	3.5	3.5
<b>Savings on under-recoveries (Rs bn)</b>	<b>159</b>	<b>315</b>
<b>Savings from capping of LPG cylinders</b>		
Reduction in LPG consumption (mn tons)	2.2	4.8
Estimated under-recovery on LPG (Rs/cylinder)	390	318
<b>Savings on under-recoveries (Rs bn)</b>	<b>61</b>	<b>107</b>
<b>Savings from lower excise duty on gasoline</b>		
Gasoline consumption for remaining part of the year (mn tons)	8.4	16.4
Reduction in excise duty on gasoline (Rs/liter)	5.3	5.3
<b>Savings for oil marketing companies (Rs bn)</b>	<b>60</b>	<b>117</b>
<b>Increase in excise collection from higher duty on diesel</b>		
Diesel consumption for remaining part of the year (mn tons)	38	74
Increase in excise duty on diesel (Rs/liter)	1.5	1.5
<b>Increase in excise collection for the Government (Rs bn)</b>	<b>68</b>	<b>135</b>

Notes:

(a) FY2013E computations reflect savings for remaining part of the year.

Source: Kotak Institutional Equities estimates

We assume 40% subsidy burden on upstream companies for FY2013E

Share of under-recoveries for various participants, March fiscal year-ends, 2007-14E (₹ bn)

	2007	2008	2009	2010	2011	2012	2013E	2014E
Dated Brent crude oil price (US\$/bbl)	65	79	89	67	84	113	110	100
Exchange rate (Rs/US\$)	45	40	46	47	46	48	55	55
<b>Gross under-recoveries</b>	<b>521</b>	<b>798</b>	<b>1,061</b>	<b>491</b>	<b>814</b>	<b>1,416</b>	<b>1,570</b>	<b>1,050</b>
Payment by government (direct budgetary support)	27	27	29	30	32	31	31	31
Payment by government (oil bonds/cash)	241	353	713	260	410	835	923	485
Share of BPCL	53	86	162	53	94	190	211	111
Share of HPCL	49	77	147	56	90	182	202	106
Share of IOCL	138	190	404	152	227	462	511	269
<b>Net under-recovery of oil companies</b>	<b>253</b>	<b>418</b>	<b>319</b>	<b>201</b>	<b>372</b>	<b>550</b>	<b>616</b>	<b>534</b>
<b>Receipt from upstream companies</b>	<b>205</b>	<b>257</b>	<b>329</b>	<b>144</b>	<b>303</b>	<b>550</b>	<b>616</b>	<b>459</b>
Share of ONGC	170	220	282	116	249	445	497	369
Share of GAIL	15	14	18	13	21	32	36	29
Share of Oil India	20	23	29	15	33	74	82	61
<b>Net under-recovery of OMCs</b>	<b>48</b>	<b>161</b>	<b>(10)</b>	<b>56</b>	<b>69</b>	<b>—</b>	<b>—</b>	<b>75</b>

Source: Company, Kotak Institutional Equities estimates

## Under-recovery will be difficult to manage at higher levels of crude price

Subsidy loss breakdown at various levels of crude oil price, March fiscal year-end, 2013E (₹ bn)

Dated Brent crude price (US\$/bbl)	100	105	110	115	120	125
LPG	301	343	385	427	469	511
Kerosene	261	279	296	314	332	349
Diesel	575	716	858	1,000	1,141	1,283
Auto fuels	575	716	858	1,000	1,141	1,283
Cooking fuels	562	621	681	741	801	861
<b>Total subsidy loss</b>	<b>1,136</b>	<b>1,338</b>	<b>1,539</b>	<b>1,741</b>	<b>1,942</b>	<b>2,144</b>
Share of upstream companies	455	535	616	696	777	857
Share of downstream companies	—	—	—	—	—	—
<b>Required compensation from government</b>	<b>682</b>	<b>803</b>	<b>924</b>	<b>1,044</b>	<b>1,165</b>	<b>1,286</b>

Source: Kotak Institutional Equities estimates

We compute meaningful savings from capping of LPG cylinders to six per household  
Savings from capping of LPG cylinders (₹ bn)

	2013E	2014E
<b>Subsidy on total consumption</b>		
LPG consumption (mn tons)	15.9	16.9
Average number of LPG households (# mn)	143	155
LPG cylinder per household (#)	7.8	7.7
Estimated under-recovery on LPG (Rs/cylinder)	390	318
Total subsidy losses (Rs bn)	436	378
<b>Subsidy capped to six cylinders per annum</b>		
Subsidized LPG consumption (mn tons)	13.7	12.1
<b>Savings in subsidy losses (Rs bn)</b>	<b>61</b>	<b>107</b>

Notes:

(a) We have assumed crude price of US\$110/bbl in FY2013E and US\$100/bbl in FY2014E.

Source: Kotak Institutional Equities estimates

## Indian energy companies valuation analysis, March fiscal year-ends, 2012-14E (X)

	Price (Rs)	Target price	KIE rating	Market cap. (US\$ mn)	P/E (X)			EV/EBITDA (X)		
	13-Sep-12	(Rs)			2012	2013E	2014E	2012	2013E	2014E
BPCL	355	410	ADD	4,627	19.6	15.6	14.9	10.4	8.6	9.3
GAIL India	370	410	ADD	8,457	12.8	11.9	11.7	8.8	7.9	7.4
HPCL	308	330	REDUCE	1,883	11.4	13.2	10.9	8.3	9.4	8.7
IOCL	255	300	ADD	11,153	7.8	11.2	9.4	5.7	7.2	7.0
ONGC	283	310	ADD	43,667	8.6	8.6	8.2	3.7	3.4	2.9
Oil India	481	590	BUY	5,220	8.4	7.7	7.4	3.9	3.0	2.5

Source: Bloomberg, Company, Kotak Institutional Equities estimates