

Industry

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Indian Downstream

 Equity

Subsidy Sharing: Back to Square One?

- **Upstream to bear 1/3rd of under-recoveries** — Providing some clarity on the subsidy-sharing formula for FY11, the oil secretary in an interview (source: *Moneycontrol*) has said that the upstream companies (ONGC, OIL, GAIL) will bear 1/3rd of FY11 gross under-recoveries, with the Gov't bearing ~50%. He also hinted that diesel deregulation was not an immediate priority, while the Kirit Parikh formula for upstream sharing was unacceptable. We believe this once again increases uncertainty for the OMCs as well as upstream companies, belying raised expectations following the last EGoM meet. We prefer GAIL at current levels, with risks to the downside for both the OMCs (BPCL, HPCL, IOC) and ONGC/OIL.
- **Uncertainty again for OMCs** — The oil secretary's statements are a negative for OMCs, which post the EGoM decision on June 25 have been pricing in expectations of full compensation of under-recoveries. With the Gov't + upstream potentially bearing ~83% of losses, it remains to be seen as to who would bear the balance, especially given the Gov't's reluctance in shouldering the same last year. In case the OMCs bear it themselves, this would result in net under-recoveries to the tune of ~Rs100bn in FY11 (at current projections of ~Rs600bn of gross under-recoveries for FY11 at US\$75 crude, incl. ~Rs200bn in 1Q) vs. Rs56bn in FY10 (see Fig 1).
- **No transparent mechanism for upstream** — Besides apportioning 1/3rd of the losses to upstream, the oil secretary has further said that the Kirit Parikh crude-linked subsidy-sharing formula for ONGC and OIL was "not acceptable", reducing their leverage to crude and implying that lack of a transparent mechanism for subsidy-sharing is likely to continue, at least for FY11. Besides, GAIL is now unlikely to be completely exempt, as opposed to the Kirit Parikh recommendation of it being completely removed from the subsidy net.
- **GAIL's underperformance makes it relatively better placed** — With upstream likely to share only cRs60bn of total 1Q losses of ~Rs200bn (sharing of auto fuel losses only as in FY10 would have led to a higher share of ~Rs100bn for upstream), the OMCs could report significant losses in 1Q in the absence of compensation from the Gov't. While ONGC/OIL will benefit from the lower than expected subsidy outgo and partial impact of the APM gas price hike in 1Q, valuations at 11-12x (in a scenario of 1/3rd sharing) leave room for downside. We believe that GAIL, given its structural growth drivers and significant underperformance vs. the OMCs and upstream since the EGoM meet (12-20%), remains relatively best placed.

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Subsidy Sharing: Back to Square One?

Figure 1. Subsidy-Sharing Mechanism

Rs bn	FY07	FY08	FY09	FY10	1QFY11E ¹	FY11E ²
Gross under-recoveries	494	771	1,033	461	200	600
of which:						
-Petrol	20	73	52	52	20	20
-Diesel	188	352	523	93	80	200
-LPG	107	155	176	143	50	195
-Kerosene	179	191	282	174	50	185
Upstream share	205	257	320	144	60	200
% upstream share	42%	33%	31%	31%	30%	33%
Govt. compensation (oil bonds/cash)	241	353	713	260	-	300
Net under-recoveries (absorbed by OMCs)	48	161	-	56	140	100

Source: CIRA estimates, PPAC ¹Based on pre-EGoM pricing and assuming no govt-compensation in 1Q ²Projections based on US\$75/bbl crude and Rs200bn subsidy for 1Q

Figure 2. Valuation Summary

Company	RIC	Rating	Mkt cap (US\$m)	Share price 15-Jul	Target price	P/E (x)		EV/EBITDA (x)		P/BV (x)	
						FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
ONGC	ONGC.BO	2L	57,565	1,257	1,170	11.4	11.1	4.7	4.5	2.3	2.0
Oil India	OILI.BO	2L	6,976	1,355	1,290	11.0	10.7	4.7	4.5	2.1	1.9
GAIL	GAIL.BO	1L	12,105	446	535	15.7	13.0	9.2	8.5	3.0	2.6
BPCL	BPCL.BO	1H	5,132	663	713	10.0	9.6	7.9	7.9	1.6	1.4
HPCL	HPCL.BO	1H	3,258	449	493	6.7	6.6	6.6	6.6	1.1	1.0
IOC	IOC.BO	2H	19,622	377	355	9.6	9.3	7.2	7.0	1.6	1.4

Source: Citi Investment Research and Analysis estimates

Appendix A-1

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